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Funding and financing of local government public investment: A framework and application to five OECD countries

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Abstract

Funding and financing of local government public investment: A framework and application to five OECD countries

The bulk of government investment is done at the local level in OECD countries, representing on average 41% of total public investment. Most studies on subnational government debt focus on the regional or state level, and very few studies analyse public investment specifically by local governments. This paper aims at filling this gap, presenting a framework to analyse the key factors, which affect the capacity of local governments to fund and finance public investment, and illustrates the framework with five case studies: Denmark, Finland, Ireland, Netherlands and New Zealand.

Keywords: Public investment, fiscal federalism, intergovernmental coordination, public financing frameworks, subnational governments

JEL classification: H54, H74, R53

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Résumé

Financement de l'investissement public des collectivités locales : cadre et application dans cinq pays de l'OCDE

L'échelon local concentre l'essentiel de l'investissement public dans les pays membres de l'OCDE, et représente en moyenne 41 % de l'investissement public total. La plupart des études consacrées à la dette des administrations infranationales s'intéressent essentiellement aux régions et aux États fédérés, et très peu d'entre elles analysent l'investissement public réalisé par les collectivités locales. Ce document vise à combler cette lacune. Il fournit un cadre d'analyse des principaux facteurs qui influent sur la capacité des collectivités locales à financer les investissements publics, et illustre ce cadre à l'aide de cinq études de cas : Danemark, Finlande, Irlande, Nouvelle-Zélande et Pays-Bas.

Mots-clés : investissement public, fédéralisme budgétaire, coordination intergouvernementale, cadres de financement public, administrations infranationales

Classification JEL : H54, H74, R53

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1 A framework for assessing the drivers of municipal investment funding and financing capacity

By Camila Vammalle and Indre Bambalaite[1]

Introduction

Local governments (LGs) represent on average about 23% of general government expenditure, 41% of general government public investments and only 10% of general government debt in the OECD (Figure 1). While most studies analyse subnational governments (SNGs) in general (i.e. both regional governments[2] and LGs), few focus on the specificities of LGs. Yet, LGs play an essential role in the provision of public services and goods to citizens, but often have less revenue and expenditure autonomy than RGs[3] and are often more constrained by fiscal rules (FRs).[4] In particular, the funding and financing frameworks for municipal public investments often constrain their capacities to carry out public investments which could provide a positive economic, social or environmental benefits and increase the welfare of their citizens.

This paper aims at filling this gap, presenting a framework to analyse the key factors which affect the capacity of LGs to fund and finance public investment, and presenting five concrete case studies of funding and financing frameworks for LG public investment. The framework presented here is aligned with the OECD (2014[1]) Council Recommendation on Effective Public Investment across Levels of Government.

[1] This document was discussed at the 16th Annual Meeting of the Network on Fiscal Relations, held virtually on 3-4 December 2020. This paper derives from a project financed by the European Commission through the Structural Reform Support Program (SRSP). The authors would like to thank Hansjörg Blöchliger (ECO) for his strong support during the process, and Sean Dougherty (Head of Fiscal Network Secretariat), Teresa Ter-Minassian (consultant), Antti Moisio (CFE/ESG), Isabell Koske and Filippo Cavassini (ECO/CS) for their comments on earlier versions of this draft and Julie Corberand (Fiscal Network) for her help in finalising the document. The project team would like to express its gratitude to the European Commission, and particularly Magdalena Bos-Lewandowska (DG-Reform), for its support on this project, to the Lithuanian project leader Natalija Kazlauskienė for her contributions during the implementation, and to all the country officials for providing useful insights during the interviews for the case studies.

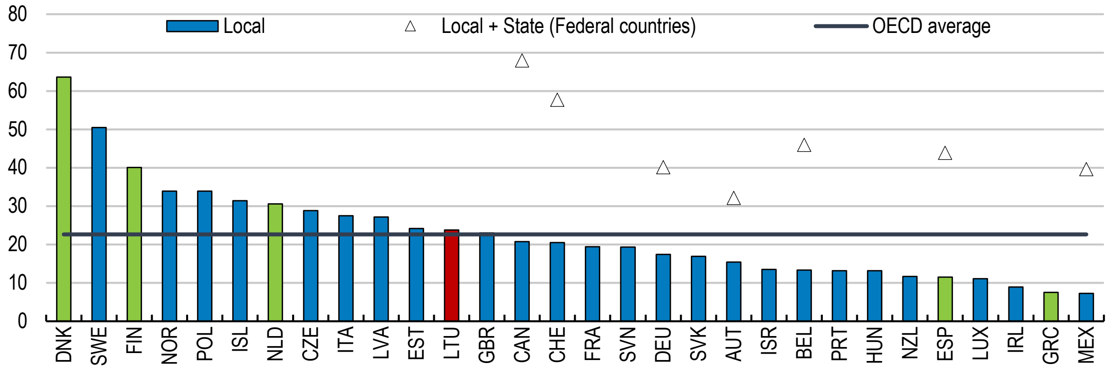
[2] The term ‘regional governments’ here refers to the first level of subnational governments only: regions, provinces, states, länders, etc.

[3] North European countries appear to be an exception to this statement, as municipalities in these countries have stronger legal status and roles than regions.

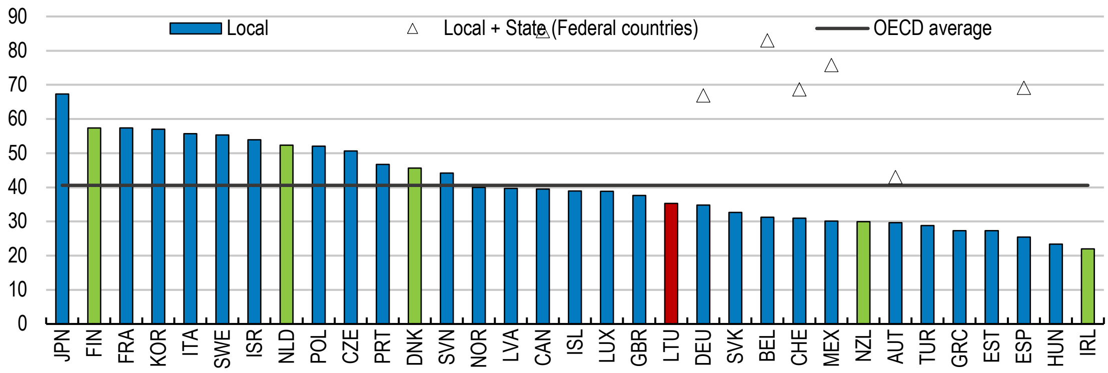
[4] See Vammalle and Bambalaite (2021[46]), “Fiscal Rules for Subnational Governments: The Devil’s in the Details”, *OECD Working Papers on Fiscal Federalism*, forthcoming.

Figure 1. Key OECD indicators of the relative weight of LGs in general government

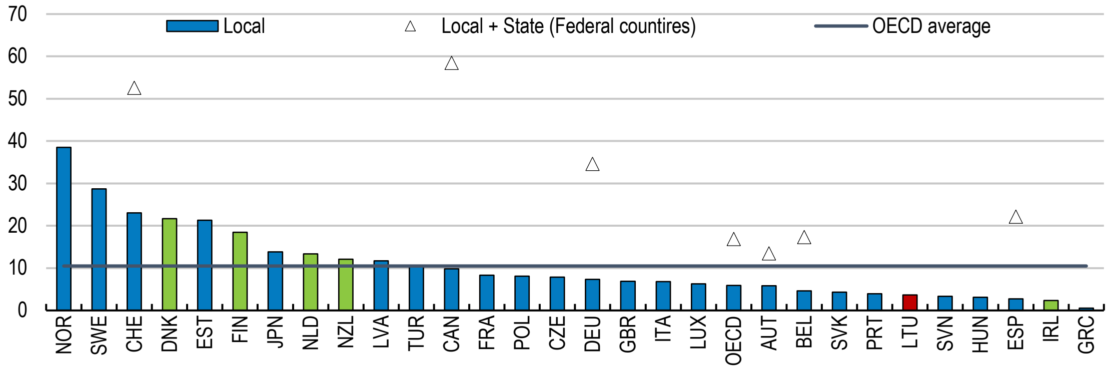
Panel A: LG expenditure, % of general government expenditure



Panel B: LG investments, % of general government investments



Panel C: LG debt, % of general government debt



Note: OECD refers to unweighted averages; Panel A: data unavailable for Australia, Chile, Japan, Korea, Turkey and United States (USA); Panel B: Gross capital formation is used as a proxy for investment (GP5P), data unavailable for Australia, Chile, USA, data for New Zealand refers to 2017; Panel C: data unavailable for Israel, Australia, Chile, Iceland, Korea, Mexico, USA. In Norway, LG debt is comparatively high, partially due to the CG deficit being covered by transfers from the Government Pension Fund Global and not by borrowing.

Source: Panel A: OECD (2019[1]), OECD Fiscal Decentralisation Database, https://www.oecd.org/ctp/federalism/fiscal-decentralisation-database.htm; Panel B: Calculations based on OECD (2019[2]), National Accounts: Government deficit/surplus, revenue, expenditure and main aggregates, https://stats.oecd.org/Index.aspx?DataSetCode=SNA_TABLE12; Panel C: OECD (2019[3]), Government at a Glance: Public Finance and Economics, https://www.oecd.org/gov/government-at-a-glance-2019-database.htm.

This paper results from a project carried out by the OECD for Lithuania, and financed by the European Commission through the Structural Reform Support Programme (SRSP), now DG-Reform. The paper develops the analytical framework in the first section, then presents the in-depth analysis of the LG investment funding and financing frameworks in five benchmark countries: Denmark, Finland, Ireland, Netherlands and New Zealand. To carry out these in-depth analyses, the OECD team developed a standard set of questions and held interviews with the relevant institutions. These were usually the Ministry of Finance/Treasury, Ministry of Interior, relevant line ministries, Association of LGs, Municipal banks (when relevant), think tanks and one or two LGs.

The case studies present each country individually (e.g. not making cross-country comparisons) and thus can be read separately. The case studies highlight the main elements of the country's framework and identifies the country's good practices, which could be of interest to other countries. The drafting of each country's case study was carried out following the internal logic of the country's framework, and at the end of each case study, a summary table presents the relative importance of the main elements based on the analytical framework structure.

Section one of this paper presents the analytical funding and financing framework for local government public investment. Sections two to six present the case study of Denmark, Finland, Ireland, Netherlands and New Zealand.

Framework

This chapter presents the analytical framework used in this project to analyse countries' municipal investment funding and financing frameworks.[5] It highlights the different elements which affect municipal investment funding and financing capacity, and how they work together successfully. The overall objective of a municipal investment funding and financing framework is to allow municipalities to carry out efficient public investment while ensuring municipal and national fiscal sustainability.

The first section describes the funding and financing sources and the multi-level governance drivers affecting the capacity of local governments to finance public investment (Box 1.1). The second section outlines how these different elements need to work together in a coherent way to ensure both efficiency and sustainability of the municipal investment-financing framework. It identifies four types of local fiscal and financial systems to ensure fiscal sustainability:[6] market based, cooperative approach, rules-based, and direct control based.

The funding and financing sources for local public investment and their determinants

Following the 2008-09 Global Financial Crisis and the trend towards tighter fiscal rules, in particular for sub-national governments (SNGs), local public investment declined in the European Union, from 1.6% of GDP in 2009 to just above 1% of GDP in 2017 (EUR 171 billion) in the EU-28 countries. Public investment in Lithuania followed the same trend.

[5] This framework draws heavily on: Vammalle, C. and C. Hulbert (2014[43]), *A sub-national perspective on financing investment for growth I – Measuring fiscal space for public investment: influences, evolution and perspectives*, https://dx.doi.org/10.1787/5jz5j1qk8fhg-en; and OECD (2014[1]), *Council Recommendation on Effective Public Investment across Levels of Government*, https://legalinstruments.oecd.org/en/instruments/OECD-LEGAL-0402.

[6] Based on Ter-Minassian, T. (1996[5]), *Borrowing by Subnational Governments: Issues and Selected International Experiences*.

Box 1.1. Funding vs. financing public investment

Not all languages have a distinction between the terms "funding" and "financing", so it is important to clarify the concepts behind these two terms, and explain why they are different in English.

Financing refers to the money needed to meet the up-front payments for public investment. Financing sources typically consist of borrowing (from commercial banks, the central government or other financial institutions), PPPs or institutional investors.

Funding refers to how the investment is ultimately paid for (loans repayments, PPP payments or investors returns). Funding typically comes from taxes, intergovernmental grants, fees, tariffs other mechanisms such as capturing land value, commercial activities, etc.

The two elements are interlinked and both are needed: indeed, if SNGs are in theory allowed to borrow (financing), but do not have sufficient capacity to increase their future revenues (funding) in order to repay the debt, they will, in practice, not be able to borrow.

The largest sources of funding financing for LG public investment in the EU are (Dexia, 2012[19]):

- Self-financing: own current revenues, or reserves accumulated through past budget surpluses;
- Capital transfers: either from CG or from supra-national institutions (such as the EU);
- Private stakeholders: through off-budget schemes such as public private partnerships, which have grown in importance in many countries over the past decade;
- Debt: borrowing on the markets, from public institutions, or CG.

The share of each funding source varies across countries and over the years, with debt-financed funding making up only a relatively small part of total local public investment. In Lithuania, local public investment makes up around 1% of GDP, overwhelmingly financed by capital transfers through the European Union's cohesion programmes.

The drivers shaping the availability of funding and financing for local public investment can be divided into six groups (Figure 1.2): the funding framework, fiscal discipline mechanisms, financial instruments, financial institutions, the public financial management system and multi-level governance.

Figure 1.2. Factors affecting the capacity of LGs to finance public investment

Note: CG – Central Government, LGFA – Local Government Financing Agency, MLG – Multi-Level Governance, PFM – Public Financial Management, PPPs – Public Private Partnerships.
Source: Authors' conception.

The funding framework refers to how the investment is ultimately paid for. The capacity to fund public investment depends on:

- **Revenue mix** refers to the share of own revenues (mainly taxes and fees) and transfers (earmarked grants and general purpose grants) in the revenues of LGs. The revenue mix determines the capacity of LGs to increase their own revenues (by raising their tax rates for example). Revenue autonomy affects LG capacity to carry out public investment, either by increasing revenues, or by borrowing (as it determines the capacity to repay loans, thus the risk and the cost of borrowing).
- **Expenditure autonomy** allows LGs to reallocate funds to higher priority areas, in particular public investment. Expenditure autonomy encourages efficiency gains as the savings can be used to fund other expenditure, in particular investment projects.
- **Donor funding** refers to capital grants from international or national institutions (other than CG). In EU countries, the main source of donor funding are the EU Cohesion and Structural Funds, which typically takes the form of capital grants. Other sources could be for example donations from philanthropy or crowdfunding.

Fiscal discipline mechanisms consist of fiscal rules and direct controls, monitoring and enforcement mechanisms and insolvency frameworks. Fiscal discipline mechanisms affect mainly the capacity of LGs to borrow to finance public investment. Indeed, while fiscal rules with stringent monitoring and enforcement mechanisms may limit the capacity of LGs to issue debt, they also increase the credibility of LG's solvability, thus making access to credit easier and lowering its cost.

Financial instruments consist on debt (loans and bonds), PPPs, and alternative financing. Loans can be regular loans from private banks or multi-lateral financial institutions (such as the EIB), from local government financing agencies or from the CG. Unlike loans which are a bilateral contract between a borrower and a lender, bonds are issued on financial markets and traded amongst a large number of investors. Bonds usually have longer maturities than loans, however, to attract investors, they must have a sufficient size and liquidity, which is rarely possible for small LGs to achieve. Alternative sources of financing are the availability of private partners to enter into public-private partnerships to finance local investment for example, special purpose vehicles or lease contracts, crowdfunding, etc. Guarantee schemes are also an important institution which can reduce cost of borrowing for LGs, and in some cases, enable them to access financial resources. Guarantees can be provided directly by the CG, or through a guarantee fund. Guarantees can be provided to individual LG loans or to pooled LGs loans.

Financial institutions refer to the intermediaries and institutions which make funds available to LGs for public investment, determine the criteria under which these funds can be accessed, and the conditions for accessing them (returnable or not, time period, cost of financing, etc.). The most frequent financial institutions for LG public investment are local government financing agencies (LGFAs) and public investment funds (created and funded by the CG or supra-national institutions such as the EU). Public investment funds refer to funds created by CGs or other public institutions to finance local public investment. These provide for example subsidised loans or capital grants.

Public financial management (PFM) systems are composed of budgeting practices, strategic planning practices and administrative capacity of LGs. Good PFM practices are necessary to plan and design quality public investment projects, increase the appetite of lenders to finance LGs' investment projects – thus increasing the capacity of LGs to borrow – and help attracting alternative funding, such as private partners for PPPs.

Multi-level governance (MLG) consists of vertical and horizontal coordination mechanisms. Vertical coordination mechanisms are necessary to align policies across levels of government, ensure monitoring of LGs' situation, and when needed, provide them technical support. Horizontal coordination allows to increase efficiency by avoiding redundancies of projects, and pooling resources together.

Four systems to ensure local fiscal efficiency and sustainability

Fiscal and financial frameworks vary greatly from country to country, with some countries giving large autonomy to LGs, for example in terms of revenue-raising capacity, expenditure decisions or borrowing rules. Other countries place a much tighter grip on LG autonomy and decision-making power. The different elements affecting LGs' capacity to finance and fund public investment are not independent of one another but are often put together to form various types of financing systems. In particular, there are different ways for ensuring LGs do not issue too much debt which could be a threat to the national fiscal sustainability.[7] Following a standard classification, there are four types of systems for ensuring SNG's fiscal sustainability. These systems also apply to LGs[8]:

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[7] For a deeper discussion on the potential risks of SNG debt, see: OECD (2016[45]), "Monitoring sub-central government debt: Trends, challenges and practices", in *Fiscal Federalism 2016, Making Decentralisation Work*.

[8] These three LG investment financing frameworks draw on the SNG borrowing frameworks presented in: Ter-Minassian, T. (1996[5]), Borrowing by Subnational Governments: Issues and Selected International Experiences.

- *Market-based systems* mainly rely on lenders to monitor local debt, ensuring the quality of debt-financed investment projects and fiscal sustainability. Market-based systems are very close to borrowing frameworks for sovereign governments. Thus, to borrow in good terms on financial markets under such systems, LGs must have a high level of capacity and autonomy. In addition, there are some pre-requisites for such systems to work effectively. For example, the "no-bailout" clause must be credible. This implies first, that LGs must be able to increase their revenues to repay their debt (for example, by having a relatively high share of taxes in LG revenues, and a high level of tax autonomy), and second that an insolvency framework provides rules to resolve unsustainable local borrowing. Lenders must have high-quality financial information on the LG, thus implying high-quality PFM systems, requiring well-functioning deep and diversified financial markets. In this type of system, fiscal rules are not very relevant, or could be self-imposed by the LG themselves.
- *Cooperative approach to debt controls.* In this approach, limits on the indebtedness of LGs are not dictated by the CG, but rather negotiated amongst the different levels of government. Under this approach, SNGs participate actively in the definition of the macroeconomic objectives and the allocation of deficit and debt targets across levels of government. According to Teresa Ter-Minassian (1996[5]), "The cooperative approach has clear advantages in promoting dialogue and exchange of information across various government levels. It also raises the consciousness, in subnational-level policymakers, of macroeconomic implications of their budgetary choices. It seems, however, to work best in countries with an established culture of relative fiscal discipline and conservatism. It may not be effective in preventing a build-up of debt in conditions where either market discipline or the leadership of the central government in economic and fiscal management are weak".
- *Rules-based systems*. Decisions on borrowing are made by LGs within limits set by central-government-set fiscal rules. Fiscal rules typically consist of limits to the absolute level of LG indebtedness, restricting borrowing to specific purposes (typically investment), setting limits to the debt-service to revenues ratio, or requiring repayment of short-term liquidity loans before the end of the fiscal year. The role of the CG in this system is usually limited to ensuring compliance with the rules. Vertical coordination mechanisms are thus very important, as well as monitoring and enforcement mechanisms. CGs rarely interfere in the choice of the investment, hence requiring a high level of capacity from LGs (to design strategic plans, procure the projects, develop the financial instruments, etc.), and good quality PFM. Rules-based systems are praised for being transparent and equitable and provide an environment in which both investors and borrowers can assess the risk of the transaction. However, they are criticised for their lack of flexibility and are often prone to circumventing of the rules (through creative accounting practices or use of debt instruments, which are not included in the fiscal rules).
- *Direct controls systems.* At the other end of the spectrum, some countries rely on direct CG control over LG borrowing. These controls can take different forms, such as setting annual limits on individual LG debt, an *ex-ante* CG review and approval of LG debt transactions, the centralisation of all borrowing at the central level, and on-lending to LGs for specific projects (usually public investment). In this type of system, the quality of investments and sustainability of LG finances is essentially ensured by CG control. Fiscal rules become almost irrelevant, with CG explicitly or implicitly guaranteeing LG debt. The responsibility to ensure sufficient revenues for LGs to repay their debts therefore lies with the CG, and revenue autonomy is not important and insolvency frameworks are not necessary. In such systems, LGs tend to have a low level of investment funding capacity, as the decision power lies at CG level. In addition, the CG itself lends to LGs, as it can do so on better conditions than private lenders. A common criticism to this type of system is that the criteria used to review and authorise borrowing operations may be variable or unclear. Insufficient capacity of LGs is often quoted by CGs to justify direct controls. However, it is rational

for LGs not to develop the capacity if they do not need to use it. Moving away from this type of system thus requires measures to reinforce the capacity of LGs.

In practice, most national frameworks consist of a mix of these four systems, although some lean more towards one or the other. As such, it is important to highlight the need for internal coherence among the different elements, which is a precondition for efficiency and sustainability of local public finances (Table 1.1). There is not one system or mix of system which could be considered as the optimal or more effective system. Indeed, different combinations of the elements can yield similar outcomes. In addition, while the government could influence some of these elements, many are constrained by exogenous factors such as the institutional framework, the existence of supra-nationally imposed fiscal rules, the level of capacity of LGs, the culture of the country and the preference of people.

Table 1.1. Interaction between elements affecting borrowing capacity under different systems

Relative importance and quality of elements encompassing institutional framework[9]

Factors affecting PI financing capacity		SNG borrowing systems			
		Market-based systems	Cooperative approach	Rule-based systems	Direct control systems
Funding	Revenue mix and expenditure autonomy	**High** SNGs can increase revenues or reallocate spending to repay debts.	**Moderate** Level of SNG revenues, expenditure and deficit are agreed between SNGs and CG.	**Moderate** A larger capacity to generate fiscal space allows a higher level of borrowing within the rules	**Low** CGs approve SNG investment projects, and ensure they have sufficient funds to finance them
Funding	Donor funding	**Low** Availability of donor funding does not affect fiscal discipline mechanisms	**Low** Availability of donor funding does not affect fiscal discipline mechanisms	**Low** Availability of donor funding does not affect fiscal discipline mechanisms	**Low** Availability of donor funding does not affect fiscal discipline mechanisms
Fiscal discipline mechanisms	Fiscal rules	**Low** Market interest rates increase when SNG debt levels rise, thus decreasing demand for loans. Some SNGs self-impose fiscal rules.	**Low** Decisions result from a negotiation process and bilateral or multi-lateral agreements. Fiscal rules and direct controls are therefore not needed.	**High** Fiscal rules are the essence of the system. The quality of the rule is key.	**Low** Fiscal rules redundant, as the CG approval for borrowing is required.
Fiscal discipline mechanisms	Direct controls	**Low** Direct government controls are not needed and could reduce effectiveness of market controls.	**Low** Decisions result from a negotiation process and bilateral or multi-lateral agreements. Fiscal rules and direct controls are therefore not needed.	**Low** If the fiscal rule is well designed, direct controls should be redundant.	**High** Direct controls are the essence of the system.
Fiscal discipline mechanisms	Monitoring and enforcement mechanisms	**Low** Monitoring of SNG debt level is carried out by lenders.	**High** Credibility of commitments is necessary to achieve agreements and relies on the trust that the commitments will be respected.	**High** The strength of monitoring and enforcement mechanisms is key in the success of the model.	**Low** The CG assesses the fiscal sustainability of SNGs and the impact of the new debt on national sustainability before granting the authorisation. Rules are therefore redundant.

[9] Please note the framework refers to the importance (high/medium/low) of each of the elements in the national system, not its quality nor stringency. Ex. "high" for fiscal rules does not mean fiscal rules are very high, but that fiscal rules are the building block of the institutional framework.

	Insolvency frameworks	**High** Insolvency frameworks allow investors to value risk, and prevent moral hazard and bailout anticipations from SNGs	**Low** The negotiation process should ensure that the agreements reached ensure fiscal sustainability, and therefore prevent SNG defaults.	**Moderate** In "normal circumstances", strict compliance with the rules avoids SNG insolvencies, and therefore insolvency frameworks are not necessary.	**Low** The CG implicitly (or explicitly) guarantees SNG debts, thus making insolvency frameworks un-necessary.
Financial institutions	CG lending	**Low**	**Low**	**Low**	**High**
	Public investment funds	**Low**	**Moderate**	**Moderate**	**High**
	LGFAs	**High**	**High**	**High**	**Low**
	Guarantees	**Low**	**Low**	**Low**	**High**
PFM Systems	Budgeting practices	**High** Adequate information on borrower's outstanding debt and repayment capacity is available to lenders.	**High** Adequate information on LG's financial positions is important for generating trust, which is a pre-requisite in this system.	**High** Clear and uniform accounting standards limiting scope for off-budget operations and clear definition of what constitutes debt avoids circumventing the rules. Timely and reliable data allows monitoring compliance with the rules.	**Low** Carried out by a CG. CG planning capacity ensures addressing the needs of the local communities.
	Strategic planning practices	**High**	**High**	**High**	**Low**
	Administrative capacity	**High** Quality of investment plans, transparency, accountability and other PFM affect the assessment of risk by lenders and therefore the cost of borrowing.	**High** High administrative capacity and negotiation skills are a key success factor in this system.	**High** Quality of investment plans, transparency, accountability and other PFM affect the assessment of risk by lenders and therefore the cost of borrowing.	**Low** Quality of investment plans is ensured by the CG. A CG (or intermediary) carries out many functions on behalf of SNGs, which thus requires less administrative capacity.
Multi-level governance	Horizontal coordination mechanisms	**Moderate** While it is not a requisite, horizontal coordination – in particular to increase size of projects and pooling of risk – can decrease borrowing costs.	**High** Mechanisms should be in place to allow negotiations and agreements amongst SNGs on how to allocate deficit and debt targets to achieve national objectives.	**Moderate** De facto coordination is achieved by following the same rules. However, while it is not a requisite, horizontal coordination – in particular to increase size of projects and pooling of risk – can decrease borrowing costs.	**Low** CG controls ensure that decisions take into account their aggregate effects. CG can also pool projects together to increase their scale and increase their effectiveness.
	Vertical co-ordination and support mechanisms	**Low** SNGs have institutional structures which ensure adequate policy responsiveness to market signals, there is no perceived chance of bailout.	**High** Multi-level dialogue and cooperation is the backbone of this system.	**Moderate** Vertical coordination ensures compliance with rules Support from CG to SNGs can improve quality of projects and alignment with national objectives	**High** SNGs usually have limited capacity, and require strong support from CG

Source: Authors' elboration.

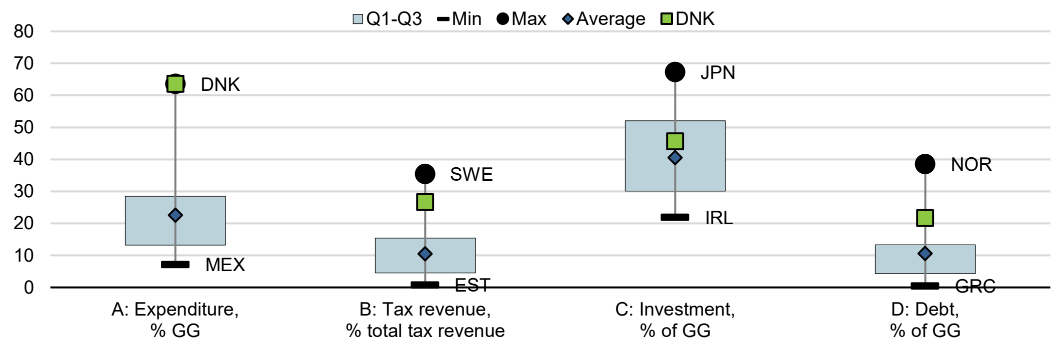
2 Denmark

This case study first presents a brief overview of the role of LGs in Denmark, then describes the main characteristics of Denmark's funding and financing framework for LG public investment. This is followed by a summary table presenting the different elements of Denmark's case, following the analytical framework presented in section one, and the last section highlights good practices identified in Denmark.

Overview of LGs' role in Denmark

Denmark is one of the most decentralised countries across OECD (Figure 2.1, Box 2.1). The Danish local sector is highly relevant both from the political and economic perspective, representing nearly two-thirds of total public expenditure. This is the highest among unitary OECD countries and nearly triple the OECD average of 23%.The main source of LG revenue is the municipal income tax, which represents up to 70 or 80% of LG revenues (and about 27% of total general government revenues). Danish local investments represent nearly half of total public investments in Denmark (46%). Moreover, Danish LG debt (about 22%) is above the OECD average of 11%.

Figure 2.1. Denmark: LG expenditure, investment and debt as a share of GG and LG tax revenues as a share of total tax revenues, 2018



Note: A: data unavailable for Australia, Chile, Japan, South Korea, Turkey and USA; B: data unavailable for Australia, Japan, Mexico; C: Gross capital formation is used as a proxy for investment (GP5P), data unavailable for Australia, Chile, USA, data for New Zealand refers to 2017; D: data unavailable for Israel, Australia, Chile, Iceland, South Korea, Mexico, USA.
Source: A: OECD (2019[1]), OECD Fiscal Decentralisation Database, https://www.oecd.org/ctp/federalism/fiscal-decentralisation-database.htm. B: OECD (2018[6]), Global Revenue Statistics, https://www.oecd.org/tax/tax-policy/global-revenue-statistics-database.htm; C: Calculations based on OECD (2019[2]), National Accounts: Government deficit/surplus, revenue, expenditure and main aggregates, https://stats.oecd.org/Index.aspx?DataSetCode=SNA_TABLE12, D: OECD (2019[3]), Government at a Glance: Public Finance and Economics, https://www.oecd.org/gov/government-at-a-glance-2019-database.htm.

Box 2.1. Territorial organisation and recent LG reforms in Denmark

Denmark has two-tiers of local government: 98 municipalities and 5 regions. Danish municipalities are among the largest in OECD with nearly 59 000 inhabitants on average.

Territorial organisation		Population and geography	
Number of tiers of government	2	Area (km2)	42 925
Number of LGs	98	Population (1000)	5 781
Average LG size (inhabitants)	58 992	Population growth	0.5
		Density (inhab/km2)	134.7
		Urban population (%)	87.8
		Population in capital city (% of total pop)	0.2

Notable reforms related to LGs in Denmark:

- 1970-2000: Several waves of decentralisation reforms between 1970 and 2000.
- 2007 reform: municipalities were granted greater responsibilities in the area of social welfare and education. However, as a trade-off, municipalities needed to accept mergers, which reduced the total number of municipalities from 270 to 98. Responsibilities in healthcare services, regional development, regional transport and the environment were moved to the regional level because of economies of scale. In the context of the 2007 reform, a new financing and equalisation system was established: municipal tax revenues were modified while new regions lost their taxing power, replaced by central government transfers.

Source: OECD (2019[7]), Making Decentralisation Work: A Handbook for Policy-Makers, https://doi.org/10.1787/g2g9faa7-en.

CG sets aggregate ceilings for municipal expenditure and tax revenues, and municipalities decide on how to allocate these amongst them

A particularity of the Danish multi-level financing system is that the CG sets every year aggregate expenditure ceilings, a "tax stop" (tax revenue ceiling) and determines a "loan pool" (additional loan options for LGs). The local government association (LGDK) represents the municipalities[10] in the negotiations of these ceilings, called "economic agreement", with the CG (Box 2.2).

Box 2.2. Local Denmark (LGDK) – a strong role in vertical coordination between CG and municipalities

Its role has been gradually strengthened since its creation and LGDK currently is one of the most influential interest organisations in Denmark. The association is not an administrative authority and thus not a part of public administration. Membership in the association is voluntary. Nonetheless, all 98 municipalities are members of LGDK.

The main functions of the association include:

- Formal negotiations of economic agreements with the Ministry of Finance;
- Mediating negotiations between individual municipalities;
- Negotiating collective bargaining agreements on behalf of municipalities with labour unions;

[10] Similarly, regions are represented by the association of regions – Danske Regioner.

- Lobbying and promoting common municipal interests;
- Counselling and shared services towards the municipalities;
- Ensuring that the municipalities are provided with all relevant and up-to-date information regarding tasks;
- Communication and branding of the municipal sector.

The work of the association is supported by 400 staff members exhibiting high administrative capacities.

Source: LGDK (2019[8]), Local Government Denmark.

Once these ceilings are set (Box 2.3), the LGDK also play a crucial role in the negotiations between the municipalities, for allocating the spending, taxing and borrowing space among themselves. The agreements are reached through a "phased budgeting procedure" established as a consequence of the Budget Law of 2012, which came into effect in 2014. This entails budget preparation procedure in two phases:

- In the first phase, LGDK conducts a survey of expenditure needs of all municipalities. Typically, Danish LGs claim higher financial needs than the ceilings set in the economic agreement.
- In the second phase, LGDK holds several meetings with mayors from the 98 municipalities, where they collectively negotiate the level of each LG's expenditure to ensure staying within the expenditure cap agreed with the CG.

LGDK plays a pivotal coordinating role in ensuring that agreed expenditure levels are met in both budgets and accounts. Once agreement on the allocation of tax revenues, expenditure ceilings and borrowing capacity for the LG sector as a whole are reached, the necessary CG transfers to municipalities are automatically allocated.

Box 2.3. The Economic Agreement of 2021

The agreement foresees the following limits on expenditure, taxes and borrowing for Danish municipalities for the budgetary year of 2021.

Expenditure caps in 2021:

- Net expenditure cap on services: 267.2 billion DKK.
- Gross expenditure cap on investments: 21.6 billion DKK.

In addition to the expenditure caps above, municipalities spend on income transfers/social benefits and on co-financing of the specialised regional healthcare system. The total sum of local expenditures is estimated to be 409.4 billion DKK in 2021.

Tax limits in 2021:

- State guaranteed total tax revenue for the whole municipal sector: 300.8 billion DKK in 2021. In comparison, the general state grant plus other state grants amount about 106.4 billion DKK.

The state guaranteed tax revenue is based on estimated development in the tax base. The total tax revenue cannot be increased.

Municipal tax revenue by source:

- Income taxes: 260.1 billion DKK;
- Corporate taxes: 7.7 billion DKK;

- Real estate taxes (private): 29.3 billion DKK;
- Real estate taxes (corporate): 3.1 billion DKK;
- Other taxes: 1.0 billion DKK
- Technical after adjustments, etc.: 0.3 billion DKK.

Loan pool limit in 2021:

Loan pool for investments subject to CG approval: 0.65 billion DKK.

Note: 100 Euros equals approximately 745 DKK (July 2020).
Source: LGDK (2020[9]), Economic Agreement 2021.

This highly institutionalised system is the result of a long tradition of a cooperative approach to local finances, where instead of market or CG setting the binding limits on expenditure and borrowing, these are achieved through active negotiation between different stakeholders. Such a system provides benefits to both CG and LGs. The CG can limit expenditure growth while allowing for local decision-making and sharing political responsibility for sometimes unpopular decisions. Moreover, LGs have an opportunity to influence public policy on a national scale while maintaining an overall flexible framework for the individual municipality (LGDK, 2019[8]).

LG are subject to a structural balanced budget rule (zero structural deficit), and borrowing is forbidden, except in some specific cases (e.g. LG public utilities, homes for elderly people, etc.) with prior approval from the Ministry of Interior

In addition to the collective current expenditure and tax limits, individual Danish municipalities are subject to a structural balanced budget rule. Moreover, in general municipal borrowing is not permitted in Denmark and municipalities typically have enough fiscal space to finance investment projects with their own funds. However, several exceptions exist. In particular, municipalities are allowed to borrow for investments in utilities as these are expenditure-neutral. This is subject to the collective capital expenditure limit (DKK 21.6 billion in 2021).

For other types of investments, municipal borrowing is subject to the annual loan pool limits, which determines the maximum aggregate amount municipalities can borrow. In 2020, the loan pool limit was equal to nearly EUR 110 million. Application to the loan pool is held once every year and the Ministry of Interior takes a discretionary decision for each borrowing request. There are similar rules for regional borrowing.

Strong fiscal monitoring deters municipalities from breaching fiscal rules

The Danish system rests on strong and tightly enforced fiscal discipline procedures, which coupled with general homogeneity of Danish municipalities creates conditions for a high level of trust and solidarity between municipalities. The Ministry of Interior closely monitors Danish municipalities and directly intervenes when certain rules are breached. Municipal bankruptcies are not legally permitted. However, a strong system of supervision and early detection of financially unsustainable behaviours allows to avoid the need for bailouts and hence limit moral hazard and potential free-riding.

There are two main fiscal discipline mechanisms for LGs in Denmark:

- If the annual collective limits of the economic agreement are breached, the CG can withhold grants to LGs. Since the introduction of this procedure after the Global Financial Crisis, LGs have not breached the collective limits for LG service expenditures. Therefore,the sanction has not been triggered.. This may be associated with successful LGDK coordination (Box 2.4). However, the tax stop limits have been breached for a few years and sanctions have been implemented consequently.

- Municipalities must keep their budget's current account balance positive over the year.[11] Breaching this provision triggers a fiscal discipline procedure (Box 2.4), where municipalities in economic distress can be put "under administration". This procedure is triggered automatically and is highly predictable with limited CG discretion. Generally, its implementation is publicly regarded as credible and being "put under administration" has a negative public image, which may negatively affect the incumbent's results in the next municipal election (Niemann, 2019[11], Mau, 2002[12]). Hence, the procedure has a strong deterrence effect, and was not used since it was established in 2008.

Box 2.4. Municipalities in economic distress are "put under administration"

The Ministry of Interior has both "the right and the obligation to react" to a violation of the rule. This is done in a standardised manner, i.e. automatically with a minimum of discretion: if the rule is broken the procedure starts and cannot normally be stopped before a plan of re-establishing a healthy financial situation has been agreed upon.

The mechanism follows a specific procedure, which was used in2008:

- The procedure is initiated at a meeting in the Ministry of Interior. The "administrative" character of the procedure is underlined by the fact that the municipal participants typically are politicians and civil servants whereas the Ministry participates solely with civil servants;
- In this and subsequent meetings, the deeper roots of the financial problems are analysed and the room for manoeuvre for the municipality is discussed;
- The municipality in question is granted a temporary approval to deviate from the overdraft rule for a certain limited period, normally three years maximum;
- This approval is given on the condition that the municipality takes steps to restore the economic situation and that such steps result in cash reserves of a certain "robust" magnitude, and that it possibly also takes steps to improve the economic management of the municipality;
- The central government may or may not add some discretionary grants – to a limited amount – to ease the immediate economic situation;
- The municipality has to report to the Ministry every three months on the economic (liquidity) situation.

The Ministry of Interior also uses an "early warning" signal when the municipal net average liquidity is less than DKK 1 000 per inhabitant.

Source: Mau (2015[12]), "Municipal bailouts in Denmark – and how to avoid them", in Kim, J. and H. Blöchliger (eds.) (2015), *Institutions of Intergovernmental Fiscal Relations: Challenges Ahead*, OECD Publishing, Paris.

[11] During the year, Danish municipalities and regions can use overdraft facilities (*kassekreditregel*) to cover unexpected cash-flow fluctuations, meaning their current account can temporarily turn negative.

Joint and several[12] municipal guarantees for KommuneKredit funding

KommuneKredit is a specialised publicly owned non-profit financial institution providing loans to Danish regions, municipalities, municipal-owned enterprises and companies undertaking regional or municipal tasks. It issues bonds on national and international markets and lends to its clients with only a small administrative margin. Legally, KommuneKredit is a voluntary membership association. Nonetheless, all Danish municipalities and regions are members.

KommuneKredit was established in 1899 to allow municipalities to access financial markets at better conditions than they could individually. Currently, KommuneKredit's market share for what they can provide lending for is approximately 100%, and its lending is 0% risk-weighted. KommuneKredit is supervised by the Ministry of Industry, Business and Financial Affairs.

KommuneKredit liabilities are jointly and severally guaranteed by all members, meaning that each member assumes the liability for the entire amount owed by KommuneKredit. The guarantee of the members can be called upon without a preceding court decision, and all municipalities are obliged to pay the creditors immediately. This guarantee is a cornerstone of the successful functioning of the institution and a key factor behind its triple-A credit rating. However, the system and monitoring procedures are such that exercising the guarantee has not been needed so far (Box 2.5).

Box 2.5. KommuneKredit's AAA credit rating

The high rating reflects KommuneKredit credit risk, which is the closest proxy to Danish sovereign risk.

The high credit rating of KommuneKredit is mainly motivated by the joint and several liability of members to all KommuneKredit's liabilities. Other factors adding to the high rating:

- strong capitalisation;
- highly creditworthy borrowers and high-quality assets;
- very strong market position (99% market share);
- its important role in the economy as the main provider of funding to the Danish local authorities.

Source: KommuneKredit (2019[13]), KommuneKredit: Corporate Presentation, https://bit.ly/3dhppzQ.

Municipalities and regions apply to KommuneKredit funding both individually and jointly, for example for bigger investments such as district heating plants. The projects must demonstrate a public purpose and fall within the criteria established by the Ministry of Interior, and must be democratically agreed on in the Municipal or Regional Councils. Importantly, municipalities themselves guarantee the timely payment of the loans taken by the municipal-owned enterprises and companies undertaking regional or municipal tasks. KommuneKredit assesses each loan application and may refuse it. However, this rarely happens as municipalities and regions are aware of the criteria.

In addition to loans, KommuneKredit also offers financial leasing, advisory services and funding for PPPs.

[12] Several guarantee means that each member assumes the liability for the total amount owned by KommuneKredit.

Summary of Denmark's framework for MFFPI in the light of the analytical framework

Denmark is a clear example of a mix between rules-based and cooperative approach for ensuring local fiscal efficiency and sustainability (Table 2.1).

Table 2.1. The institutional framework of the Danish LG sector and availability of funding options[13]

Funding	Revenue and expenditure autonomy	High	• CG transfers represent 60% of total LG revenues. • Tax raising capacity is high. Local taxes represent 36% of LG revenues. Main local tax is municipal income tax for which LGs can set the rates. • To avoid municipal income tax increases, CG imposes a tax stop on the aggregate tax revenues. Regions are mainly financed by state grants and subsidies though an equalization system. • CG guarantees sufficient financing for LGs. • High discretion over expenditures.
	Public investment grants	Low	• ESIF support is low. However, smaller municipalities sometimes engage in such practices and typically finance the matching part from their own funds rather than via borrowing.
Fiscal discipline mechanisms	Fiscal rules	High	• LGs are subject to a structural balanced budget rule (on operating and capital budgets in aggregate). • Expenditure ceiling (separate for services and capital expenditure) – ceiling on aggregate LG expenditure, not on individual municipalities.
	Direct controls	Extremely high	• Generally, borrowing is not permitted. Several exceptions exist: borrowing for utility services and borrowing with a prior agreement for other types of investments is allowed. .
	Monitoring and enforcement mechanisms	Extremely high	• Compliance with fiscal rules is monitored by the Economic Council within the Ministry of Interior. • In case of non-compliance, with the fiscal rules, gaps must be compensated the following year. The CG may reduce transfers. • In case of the breach of the overdraft facility, an automatic correction procedure is triggered and municipalities are "put under administration" until fiscal sustainability objectives are reached.
	Insolvency frameworks	Low	• Municipal bankruptcies are not allowed.
Financial instruments	Loans	High	• Municipalities do not rely on commercial debt. However, reliance on loans is high, as the KommuneKredit loans are a preferred investment financing option for Danish municipalities.
	Bonds	Moderate	• Municipalities do not issue individual bonds. • KommuneKredit places bonds on financial markets.
	PPPs and other alternative financing	Low	• Municipalities and regions sometimes engage in PPP agreements. KommuneKredit may provide funding for PPPs
	Guarantees	High	• Municipalities jointly and severally guarantee KommuneKredit funding
Financial institutions	CG lending	Low	• CG does not lend to municipalities.
	Public investment funds	Low	• PI funds are not prevalent in Denmark.
	LGFAs	High	• KommuneKredit, a LG-owned bank providing lending and financial leases, holds 99% of SNG loans.
PFM systems	Budgeting and reporting practices	Moderate	• LGs use cash accounting but prepare budgets on accrual basis. • High level of budgetary transparency. • Expenditure ceilings are decided for one year. Budget Act is scheduled to be revised in February 2021.
	Strategic planning practices	Low	• Municipalities do not prepare overall long-term strategic infrastructure plans, but sectoral plans exist.
	Administrative capacity	High	• There are no differences in terms of administrative capacities across Danish municipalities due to homogeneity of municipalities.
Mult	Vertical	High	• There is a strong vertical coordination where the association of Local Government (Local Denmark

[13] Please note the framework refers to the importance (high/medium/low) of each of the elements in the national system, not its quality nor stringency.

	coordination and support mechanisms		(LGDK)) negotiates collective expenditure, taxation and loan pool limits with the CG. The Ministry of Interior is the main contact point for LGs at the CG level and monitors LGs' financial situation.
	Inter-municipal (horizontal) coordination and cooperation	**High**	• There is a particularly strong horizontal coordination between LGs, which must allocate among themselves the ceilings set by the CG for aggregate expenditure, taxes and debts of LGs. These negotiations are facilitated by the association of Danish LGs (LGDK)

Good practices from Denmark

This case study highlights a number of good practices and conditions for success in the framework for budging and financing LG public investment:

- Strong LG tax autonomy
- High level of discretion over expenditures
- One clear structural balanced budget rule
- Negotiation of fiscal rules and borrowing limits between LGs and CG
- A strong role of LG association in vertical coordination
- Very strong automatic enforcement mechanisms in case of breaching the rules
- A municipal financial institution that raises funds on national and international markets with all municipalities as members
- Municipalities jointly and severally guarantee KommuneKredit liabilities

Interviewed institutions

The mission to Denmark took place virtually between the 11 June and the 24 June 2020.

Institutions interviewed
Association of Local Governments (LGDK)
Vive – The Danish Center for Social Science Research
KommuneKredit

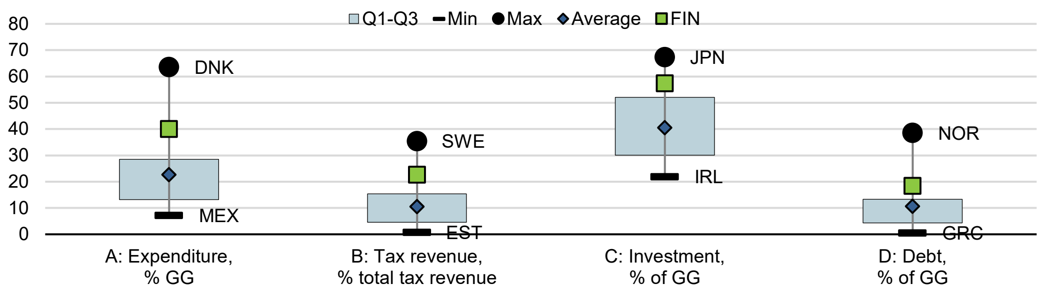
3 Finland

This case study first presents a brief overview of the role of LGs in Finland, then describes the main characteristics of Finland's funding and financing framework for LG public investment. This is followed by a summary table presenting the different elements of Finland's case, following the analytical framework presented in section one, and the last section highlights good practices identified in Finland.

Overview of LGs' role in Finland

Finland is a highly decentralised country with a very large role of LGs in public investment. About 57% of public investment is carried out at the local level (Figure 3.1). LG expenditure level as a share of general government expenditure (40%) is well above OECD average of 23%. Moreover, LGs' tax raising capacity is relatively high compared to OECD counterparts, representing about 23% of total public tax revenue. Municipal debt accounts for 18% of total general government debt in Finland.

Figure 3.1. Finland: LG expenditure, investment and debt as a share of GG and LG tax revenues as a share of total tax revenues, 2018



Note: A: data unavailable for Australia, Chile, Japan, South Korea, Turkey and USA; B: data unavailable for Australia, Japan, Mexico; C: Gross capital formation is used as a proxy for investment (GP5P), data unavailable for Australia, Chile, USA, data for New Zealand refers to 2017; D: data unavailable for Israel, Australia, Chile, Iceland, South Korea, Mexico, USA.
Source: A: OECD (2019[1]), OECD Fiscal Decentralisation Database, https://www.oecd.org/ctp/federalism/fiscal-decentralisation-database.htm. B: OECD (2018[6]), Global Revenue Statistics, https://www.oecd.org/tax/tax-policy/global-revenue-statistics-database.htm; C: Calculations based on OECD (2019[2]), National Accounts: Government deficit/surplus, revenue, expenditure and main aggregates, https://stats.oecd.org/Index.aspx?DataSetCode=SNA_TABLE12, D: OECD (2019[3]), Government at a Glance: Public Finance and Economics, https://www.oecd.org/gov/government-at-a-glance-2019-database.htm.

The distinctive feature of the Finnish LG institutional framework is the exceptionally large discretion granted to municipalities to spend, borrow and invest, as long as they remain within pre-defined and tightly enforced limits (Box 3.3). Finnish municipalities also enjoy very low borrowing costs (close to the sovereign) thanks to two factors: the municipal credit risk is close to the sovereign, and the pooling of risks and funding needs through a municipal-owned financial institution (MuniFin) and a Municipal Guarantee Board.

Box 3.1. Territorial organisation and recent LG reforms in Finland

Finland has a two-tier local government system with 18 autonomous elected regions and 311 municipalities.

Territorial organisation		Population and geography	
Number of tiers of government	2	Area (km2)	338 441
Number of LGs	311	Population (1000)	5 513
Average LG size (inhabitants)	17 727	Population growth	0.4
		Density (inhab/km2)	16.3
		Urban population (%)	84.4
		Population in capital city (% of total pop)	12

Notable reforms related to LGs in Finland:

- 1995: A new enabling Local Government Act gave local governments more freedom to organise their affairs, based on the experimentation of the “Free Commune Act” (1988); major reform of grants system.
- 1999: Local autonomy is guaranteed by the 1999 Constitution.
- 2007: PARAS reform (Act on Restructuring Local Government and Services).
- Currently: discussions in Parliament on a proposal to create 22 autonomous elected regions (replacing the joint municipal bodies) having responsibility for the organisation of healthcare and social services (transferred from joint municipal authorities, local authorities and central government).

Source: OECD (2019[14]), Making Decentralisation Work: A Handbook for Policy-Makers, OECD Multi-level Governance Studies, OECD Publishing, Paris. https://doi.org/10.1787/g2g9faa7-en.

The Finnish municipal borrowing framework can be considered as a mix of rules-based and market-based systems. The summary table (Table 3.1) provides details on the institutional framework of the Finnish municipal sector.

Box 3.2. Local Government Act: Budget and Financial Planning

- By the end of each year, local councils shall approve a budget for the municipality for the next calendar year, taking into account the financial responsibilities and obligations of the local authority corporation. In connection with the budget approval, local councils shall also approve a financial plan for three or more years (planning period). The budget year shall be the first year of the financial plan.
- The budget and financial plan shall be drawn up so as to put the municipal strategy into effect and to secure the preconditions for the performance of the municipality's functions. The operating and financial targets of the municipality and the local authority corporation shall be approved in the budget and financial plan.
- The financial plan shall be in balance or in surplus. A deficit in the municipality's balance sheet shall be covered within no more than four years from the start of the year following adoption of the financial statements. In its financial plan, the municipality decides on the specific measures for covering the deficit during the stated period.
- The budget shall include the appropriations and revenue estimates required to fulfil the duties and meet the operating targets, and an indication of how the financing requirement will be covered. The appropriations and the revenue estimates may be stated in gross or net terms. Budgets and financial plans have a section covering operational finances and an income statement, and a section on investment and financing.
- The budget shall be adhered to in the municipality's activities and financial management.
- The deficit coverage obligation, provided in subsection 3 above, shall also apply to joint municipal authorities

Source: Local Government Act (2020[15]), Section 110, available at https://bit.ly/2WAEA0Z.

The Finish framework for municipal funding and financing of public investment

Three institutional and governance elements play a crucial role in ensuring the high average creditworthiness of Finnish municipalities, giving them a credit rating close to the sovereign:

- *A long tradition of municipal self-government and high administrative capacity*. Finland enjoys a long tradition of municipal autonomy and bottom-up policy-making. Municipal self-government is anchored in the Constitution. These long-standing multi-level governance relations created a high level of trust in a municipal decision-making capacity, in turn creating conditions for building up administrative capabilities necessary to carry out complex tasks, especially in large cities. Municipal PFM practices are also very advanced: municipalities use accrual accounting since 1997, and each year, municipal councils approve both the annual budget and a financial plan for three or more years (Box 3.2). Municipalities must develop strategic and investment plans for 10 years.
- *Unlimited tax-raising capacity.* Finnish municipalities enjoy high levels of fiscal autonomy. Own taxes represent on average 50% of their revenues, and they can freely set the municipal personal

income tax rate.[14] Municipal personal income tax rates vary from 16.5% to 22.5%, with no signs of a race-to-the-bottom.

- *Tight fiscal supervision,* coupled with strong enforcement mechanisms. There are no formal borrowing rules. However, Finnish municipalities are subject to a balanced budget rule: they must present financial plans in balance or surplus and must cover any deficit within a period of four years (Box 3.2). Breaching specific financial sustainability criteria set by the Ministry of Finance (Box 3.3) triggers a special assessment process: officials from the Ministry of Finance visit municipalities "in crisis" providing advice on how to improve their financial situation and assist them in developing correction plans. In case of severe non-compliance, CG has the legal authority to force municipal mergers. Such forced mergers are rare, but have happened four times since the introduction of the mechanism in the year 2015, and being a municipality "in assessment" carries a negative connotation in terms of public image. In order to avoid this situation, and also following a shared understanding on the importance of running sustainable finances, some municipalities self-impose even tighter financial sustainability indicators. This tight fiscal supervision, coupled with strong enforcement instruments, acts as a strong preventative measure incentivising Finnish municipalities to manage their finances sustainably.
- *Strong peer pressure and market incentives*. All Finnish municipalities jointly guarantee the Municipal Guarantee Board, and therefore, indirectly guarantee all other municipal loans. As developed in the next section, the Municipal Guarantee Board assesses the sustainability of municipalities before approving a guarantee, and MuniFin follows that advice for approving loans. Municipalities therefore have a strong incentive to maintain strong financial positions, as otherwise, they would not be able to access the cheap financing through MuniFin.

Box 3.3. Criteria for triggering the assessment mechanism in Finland

Criteria laid down in the Local Government Act:

1. The assessment procedure may be started if a municipality has not covered the deficit in its balance sheet within the four-year period.
2. The assessment procedure may also be started if the latest consolidated financial statement of the municipality shows a deficit of at least EUR 1 000 per resident and the preceding financial statement a deficit of at least EUR 500 per resident, or if the financial key figures for finance adequacy or solvency have reached the following limits in *two successive years*:
    a. The ratio between the annual contribution margin and the depreciations falls below 80% in the consolidated income statement of the municipality;
    b. The municipality's rate of local income tax is at least 2 percentage points higher than the weighted average rate of local income tax of all municipalities;
    c. The amount of the loans and rental liabilities in the consolidated financial statement of the municipality per resident exceeds the average amount of loans and rental liabilities in the consolidated financial statements of all municipalities by at least 50%;
    d. The computational loan coverage ratio of the consolidated financial statement falls below 0.8%.

Note: the computational loan coverage ratio is calculated using a formula where interest income is added to the annual contribution margin of the consolidated income statement and the resulting amount is divided by the amount of interest income and computational loan repayments. The computational loan payments shall be arrived at by dividing the amount of loans by eight.
Source: Local Government Act (2020[15]), Section 118, available at https://bit.ly/2WAEA0Z.

[14] Right to levy the municipal tax is defined in the Constitution. The effective local income tax rate may differ from the nominal rate as the CG can decide upon deductions.

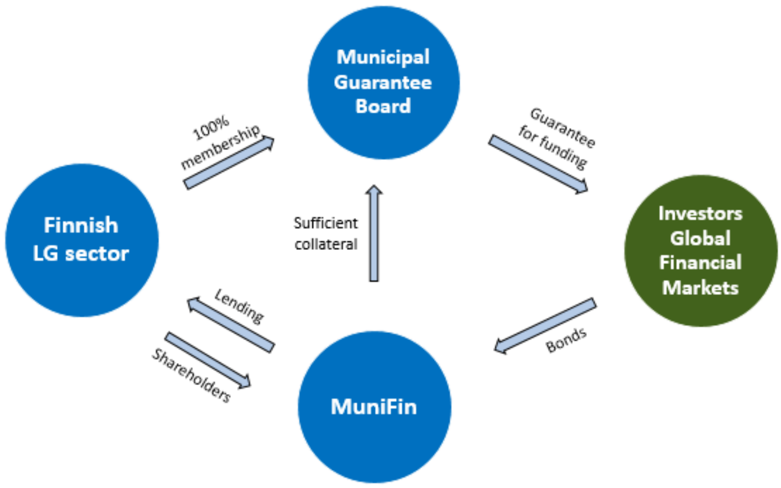
The joint funding system of municipalities through MuniFin and the Municipal Guarantee Board

Finnish municipalities enjoy extremely low borrowing costs thanks to the joint work of two financial institutions: MuniFin and the Municipal Guarantee Board.

MuniFin is a specialised financial[15,16] institution owned primarily by the Finnish municipalities.[17] MuniFin pools the funding needs of Finnish municipalities, municipal enterprises and non-profit organisation, and issues bonds on global financial markets (Figure 3.2).

The funding of the MuniFin is explicitly guaranteed by the Municipal Guarantee Board (Figure 3.2 and Box 3.4), which allows MuniFin to place bonds at very favourable conditions. The Municipal Guarantee Board uses the loans from MuniFin as collateral and can only guarantee loans issued by MuniFin. To ensure the quality of the collateral, the Municipal Guarantee Board could refuse a loan as collateral, in which case, MuniFin would also reject that loan. Given the high credibility of municipalities' capacity to repay and the 100% participation of municipalities both in MuniFin and in the Municipal Guarantee Board, international investors perceive credit risk of MuniFin as close to the sovereign.[18] MuniFin and the Municipal Guarantee Board have low operating expenditure and do not seek to make profits, and therefore lending rates from MuniFin to municipalities are extremely low and competitive.

Figure 3.2. Finnish municipalities joint funding system institutional framework



Source: MuniFin (2019[16]), *MuniFin Presentation: building tomorrow*.

As a result, around 80% of municipal debt is financed through MuniFin (André and García, 2014[17]). Even large cities that engage in a wide variety of financial instruments, including issuing their own bonds, mainly rely on funding from MuniFin. For example, 68% of all loans in the city of Espoo, the second-largest municipality in Finland, come from MuniFin.

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[15] The Financial Supervisory Authority supervises the MuniFin and the ECB acts as a watchdog.

[16] The MuniFin is not allowed to take deposits thus cannot be considered a bank.

[17] The municipalities own 53% of MuniFin shares (all municipalities participate), KeVa (the largest pension fund) – 31% and the state – 16%.

[18] In May 2020, the credit ratings of both MuniFin and the Municipal Guarantee Board were Aa1 from Moody's and AA+ from Standard & Poor's.

MuniFin rarely formally rejects funding applications because it participates in the elaboration of projects from early stages. In case of financial difficulties, municipalities have an option to restructure loans or extend the repayment periods, but this is rarely practised.

Today, MuniFin is facing increased competition from commercial banks and even investment promotion banks such as the European Investment Bank, which use low-risk Finnish municipalities to reduce the risk exposure of their portfolio.

Box 3.4. Municipal Guarantee Board

The Municipal Guarantee Board (MGB) was established in 1996 in the context of the Act on the Municipal Guarantee Board. Its purpose is to safeguard and develop the joint funding of Finnish municipalities.

The MGB provides zero-risk weighted explicit guarantees for MuniFin funding, backed by the unlimited right of municipalities to levy taxes. All municipalities of mainland Finland[19] are members of the MGB and pay membership fees, which are used to cover administrative expenses. The MGB guarantees carry AA+ ratings, which are capped to the rating of the State of Finland.

The MGB provides a supporting function. It can inject any amount of money to keep the MuniFin from collapsing. In particular, the MGB can access the municipal tax base if needed. Importantly, the MGB guarantees MuniFin’s loans/bonds, not municipalities’ individual loans. Each entity is responsible for its own loans.

In case of non-payment by MuniFin, the MGB would pay the investors firstly and issue a bill to all municipalities. Later, it would adjust the balances for municipalities that over or underpaid.

The MGB comprise 15 council members appointed by the Ministry of Finance, seven board of director members and an MGB auditor appointed by the Ministry of Finance.

A strong vertical coordination structure in the Ministry of Finance

The Ministry of Finance develops regulations that generally relates to the local authorities. Over the last decade, multiple reforms have reinforced the central role of the Ministry of Finance in municipal affairs.[20] The Local Government Affairs department monitors and assesses the status and development of the finances of municipalities. It follows a set of indicators and meets regularly with the financial unit of municipalities. The Ministry of Finance publishes detailed financial information with already built-in analytical tools (ability to select a municipality and weight it against the regional and national averages).

The Local Government Affairs department is now responsible for more than 80% of grant allocations to municipalities. The remaining grant allocation is executed by the Ministry of Education (around 10%) and the Ministry of Health and Social Affairs (around 6%). Moreover, the Local Government Affairs department at the Ministry of Finance closely collaborates with the Association of Finnish Local and Regional Authorities, which can take part in workgroups of ministries, when they prepare reports.

Summary of Finland’s framework for MFFFPI in light of the analytical framework

Finland is a clear example of a rules-based system and market-based systems for ensuring LG fiscal efficiency and sustainability (Table 3.1).

[19] Province of Åland is autonomous and thus not a member.

[20] See Blöchliger, H. and C. Vammalle (2012[42]), *Reforming Fiscal Federalism and Local Government: Beyond the Zero-Sum Game*, http://dx.doi.org/10.1787/9789264119970-en.

Table 3.1. The institutional framework of the Finnish LG sector and availability of funding options[21]

Funding	Revenue and expenditure autonomy	**Extremely High**	• CG transfers represent only 32% of total LG revenues. Grant allocation is centralised mainly in the Ministry of Finance. • Tax raising capacity is high representing 46% of total LG revenues. Unlimited right of LGs to levy the Personal Income Tax (PIT). This gives municipalities a risk close to the sovereign. • Long tradition of strong LGs' autonomy. • High discretion over expenditures.
Funding	Public investment grants	**Low**	• Municipalities mostly use MuniFin loans to fund investments and barely rely on the assistance from the EU or other international organisations
Fiscal discipline mechanisms	Fiscal rules	**Moderate**	• Strict and tightly enforced balanced budget rule. LGs must present financial plans in balance or surplus (calculated in accruals and including both capital and operating budgets), and if a deficit happens, it must be covered within four years.
Fiscal discipline mechanisms	Direct controls	**Low**	• Municipalities are allowed to act at their own discretion as long as they are within the established rules.
Fiscal discipline mechanisms	Monitoring and enforcement mechanisms	**Extremely high**	• The MoF monitors five deficit and debt indicators. If indicators break the threshold, municipality enters the "assessment mechanism" and must develop a correction plan together with the Ministry of Finance. • In severe non-compliance, municipal mergers can be imposed, but such cases are very rare. • Strong scrutiny of municipal fiscal position from the Municipal Guarantee board and MuniFin for approving loans
Fiscal discipline mechanisms	Insolvency frameworks	**Low**	• No formal insolvency mechanism. Early prevention mechanisms make municipal default very unlikely.
Financial instruments	Loans	**High**	• Municipalities heavily rely on loans, most of which are from from MuniFin. • Only biggest municipalities take loans from commercial banks. • Finnish municipalities are able to attract international investors (e.g. EIB, EBRD).
Financial instruments	Bonds	**High**	• The biggest municipalities issue their own bonds. • MuniFin places bonds on financial markets.
Financial instruments	PPPs and other alternative financing	**Moderate**	• LGs were not allowed to use PPPs until 2018. Since there are only 5-6 providers in the market, therefore, capacity constraints are high. • Real-estate leasing and repurposing are actively used.
Financial instruments	Guarantees	**High**	• MuniFin funding is guaranteed by the Municipal Guarantee Board.
Financial institutions	CG lending	**Low**	• CG does not lend to municipalities.
Financial institutions	Public investment funds	**Low**	• PI funds are not prevalent.
Financial institutions	LGFAs	**High**	• The MuniFin – a specialized municipality-owned financial institution pools municipal risk and provides loans to Finnish municipalities drawing on resources from financial markets.
PFM systems	Budgeting and reporting practices	**High**	• Municipalities use accrual accounting. • Municipalities must present a financial plan for at least three years in addition to the annual budget. • Municipalities must provide updated financial data to the Statistical Authority four times a year. The MoF uses these data to assess municipalities' fiscal position once a year in June. • Financial information is published with built-in analytical tool.
PFM systems	Strategic planning practices	**High**	• LGs must prepare 10 years strategic and investment plans. • Larger municipalities use sophisticated financial management tools to plan their investments.
PFM systems	Administrative capacity	**High**	• Reliance on highly skilled municipal civil servants.
Multi-level governance	Vertical coordination and support mechanisms	**High**	• A special department within the MoF routinely assesses municipalities' finances and can assist municipalities "in very difficult financial position" in developing correction plans. • Local Association of Local and Regional Authorities lobbies to secure and improve local government functions at the CG and the EU levels. A subsidiary of the Association provides consultancy services for bigger investments through a separately established entity.
Multi-level governance	Inter-municipal (horizontal) coordination and cooperation	**High**	• Voluntary inter-municipal co-operation is very common, usually through joint municipal authorities. • In specialised healthcare and regional planning, LGs are obliged to form such joint municipal authorities.

Good practices from Finland's framework

This case study highlights a number of good practices and conditions for success in the framework for budging and financing LG public investment:

- Very high level of tax autonomy of LGs
- A simple, predictable and centralized grant system
- Very high level of financial management capacity of LGs
- High level of transparency and reporting mechanisms
- Only one very clearly stated fiscal rule
- Very strong monitoring mechanism, with five indicators, clearly identified
- Very strong enforcement mechanism in case of breaching the rules
- Very clear vertical coordination mechanism, with one department in Ministry of Finance responsible for all fiscal issues related to LGs.
- Municipal financial institution, which includes at least the largest LGs, ideally 100% coverage
- Municipal guarantee board to pool credit risk, which includes at least the largest LGs, ideally 100% coverage
- Strong market incentive to maintain good fiscal sustainability indicators in order to benefit from cheap loans from the municipal financial institution

Interviewed institutions

The mission to Finland took place on the 4-5 of December 2019. A Lithuanian delegation attended all the meetings together with OECD secretariat.

Interviewed institutions
The Ministry of Finance
The Association of Finnish Local and Regional Authorities
MuniFin – Municipal Bank
Municipal Guarantee Board
Administration of the city of Porvoo
Administration of the city of Espoo

[21] Please note the framework refers to the importance (high/medium/low) of each of the elements in the national system, not its quality nor stringency.

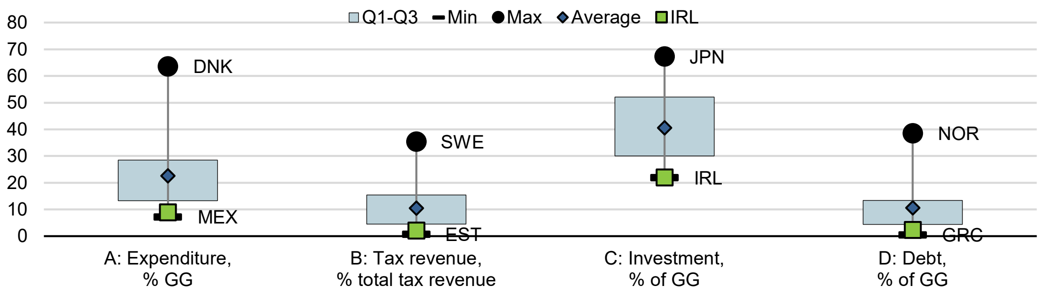
4 Ireland

This case study first presents a brief overview of the role of LGs in Ireland, then describes the main characteristics of Ireland's funding and financing framework for LG public investment. This is followed by a summary table presenting the different elements of Ireland's case, following the analytical framework presented in section one, and the last section highlights good practices identified in Ireland.

Overview of LGs' role in Ireland

Ireland is one of the most centralised countries across OECD (Box 4.1). The thirty-one local authorities in Ireland carry out only 22% of total public investment – the lowest number among OECD. Municipal expenditures represent only about 9% of general government expenditure and LGs' tax raising capacity is particularly low, only 2% of total public tax revenue.

Figure 4.1. Ireland: LG expenditure, investment and debt as a share of GG and LG tax revenues as a share of total tax revenues, 2018



Note: A: data unavailable for Australia, Chile, Japan, South Korea, Turkey and USA; B: data unavailable for Australia, Japan, Mexico; C: Gross capital formation is used as a proxy for investment (GP5P), data unavailable for Australia, Chile, USA, data for New Zealand refers to 2017; D: data unavailable for Israel, Australia, Chile, Iceland, South Korea, Mexico, USA.
Source: A: OECD (2019[1]), OECD Fiscal Decentralisation Database, https://www.oecd.org/ctp/federalism/fiscal-decentralisation-database.htm. B: OECD (2018[6]), Global Revenue Statistics, https://www.oecd.org/tax/tax-policy/global-revenue-statistics-database.htm; C: Calculations based on OECD (2019[2]), National Accounts: Government deficit/surplus, revenue, expenditure and main aggregates, https://stats.oecd.org/Index.aspx?DataSetCode=SNA_TABLE12, D: OECD (2019[3]), Government at a Glance: Public Finance and Economics, https://www.oecd.org/gov/government-at-a-glance-2019-database.htm.

In Ireland, the CG has significant control over LG affairs. LG autonomy is very limited both in terms of own-revenue raising capacity and discretion over spending (Box 4.1). Nonetheless, Irish municipalities are allowed to borrow from state-owned agencies with prior CG approval. The CG establishes each year a total debt ceiling for LG new borrowing (it is EUR 200 million for 2020 for example). Against this background, the Irish investment funding system can be considered as *direct control*.

Box 4.1. Territorial organisation and recent LG reforms in Ireland

Ireland has one-tier local government system with 31 large municipalities, which have over 155 000 inhabitants, on average.

Territorial organisation		Population and geography	
Number of tiers of government	1	Area (km2)	69 947
Number of LGs	31	Population (1000)	4830
Average LG size (inhabitants)	155819	Population growth	0.3
		Density (inhab/km2)	69.1
		Urban population (%)	62.9
		Population in capital city (% of total pop)	25

Notable reforms related to LGs in Ireland:

- 2001: Local Government Act introduced the range of reforms set out under "Better Local Government" White Paper.
- 2012: "Reforming Local Government" plan and "Putting People First Report" deal with issues of structures, functions, funding, efficiency and service, and governance and accountability, the goals being to strengthen local authorities' responsibilities, functions, leadership and financing mechanisms.
- 2013: Introduction of a local property tax with rate-setting powers at the margin.
- 2014: Local Government Reform Act merged 114 local councils into 31 local governments, abolished the previous 8 regional authorities (replaced by 3 regional assemblies, not elected by universal suffrage) and clarified the allocation of responsibilities, reassignment of water services to Irish Water. Recentralisation of some functions and allocation of several new responsibilities for local and community development, in addition to an enterprise support and economic development role.

Source: OECD (2019[14]), Making Decentralisation Work: A Handbook for Policy-Makers, OECD Multi-level Governance Studies, OECD Publishing, Paris. https://doi.org/10.1787/g2g9faa7-en.

Ireland joined the EU in 1973 and was an important beneficiary of EU funds until the early 2000's. As Ireland developed, it transitioned away from EU funds, and has now been a net contributory for about a decade. While the EU funds were extremely useful in financing the necessary infrastructure, Ireland also sees the culture of planning and strict selection and evaluation processes as a significant legacy of the EU structural funds experience. During its transition from the Cohesion period[22] towards a CG funded investment financing framework, Ireland has kept and developed this investment planning culture, and created its own funds and institutions to finance local public investment after the fading out of EU funds. In addition, Ireland has heavily invested EU funds in human capital rather than solely spending on infrastructure, devoting over 1/3 of the EU structural funds to investments in human capital (unlike other cohesion countries which joined at the same period, such as Greece, Italy, or Spain).

[22] The Cohesion period is defined as a period between when a new member state joins the European Union and intensively benefits from the Cohesion fund support until it passes to a transitioning and later a developed EU countries group.

The Irish framework for municipal funding and financing of public investment

Continuous efforts in PFM and administrative capacity building

During its transition towards a developed economy, Ireland has benefited from the EU structural funds not only in monetary terms but also in building a solid capacity for executing capital investments. Ireland has endorsed through its local legislation the discipline elements taken from the EU structural funds framework: evaluations, appraisals, multi-annual development and budgetary plans. This was reinforced by Ireland's strong focus on investments in human capital.

Strong vertical coordination mechanism

The Department of Housing, Planning and Local Government has the overall responsibility for municipal affairs. Within the Department, the Local Government Division co-ordinates planning and monitors the financial health of local authorities, offering guidance and advice for sustainable financial planning. If a local authority faces severe financial difficulties, the Local Government Division elaborates a plan and a funding package for five years, with special financial targets to be achieved by the local authority.

Funding follows the policy: a comprehensive strategic planning framework

One of the cornerstones of the Irish public investment financing framework is comprehensive multi-annual planning involving multi-stakeholder public consultations and strong enforcement of policy priorities: "*Funding follows policy, not policy follows funding*".

Ireland has a strong integration of financial plans with regional development plans. In 2018, it launched Project Ireland 2040 (Box 4.2), which articulates the National Planning Framework to 2040 and the National Development Plan (to 2027). These plans also set the context for Ireland's three regional assemblies to develop their regional spatial and economic strategies, coordinating with the local authorities, to ensure that national, regional and local plans align. The Office of the Planning Regulator ensures this coordination by overseeing and approving the plans from all levels of government.

Box 4.2. Strategic planning in Ireland: Project Ireland 2040

Project Ireland 2040 is the Irish government's long-term overarching strategy. Established in 2018, it changes how investment is made in public infrastructure in Ireland, moving away from the approach of the past, which saw public investment spread too thinly and investment decisions that did not align with a well-thought-out and defined strategy.

National Planning Framework

In the context of Project Ireland 2040, the Government established a strategic planning framework – National Planning Framework – to guide the development of the country in economic, social and environmental terms. The National Planning Framework was prepared by the Department of Housing, Planning and Local Governments (DHPLG), following widespread public consultations. The Office of the Planning Regulator is responsible for monitoring the implementation of the National Planning Framework through local development plans and regional and economic spatial strategies.

National Development Plan

The National Development Plan 2018-2027 was published in conjunction with the National Planning Framework, and sets out the capital investment required to implement the National Planning Framework. The plan is backed by investment of EUR 116 billion over the 10 years to 2027, including

EUR 1 billion to the Rural Regeneration and Development Fund (URDF) and EUR 2 billion to the Urban Regeneration and Development Fund (URDF).

Regional planning

The National Planning Framework and the National Development Plan set the context for each of Ireland's three regional assemblies to develop their Regional Spatial and Economic Strategies which co-ordinate the both the development plans and local economic and community plans of local authorities. The Office of the Planning Regulator is a statutory consultee in the process of preparing the regional strategies.

Development plans and Local Area Plans

The Development plan is a local authority's main policy document in relation to planning. It is prepared by the elected members of the local authority. The development plan sets out the overall core strategy and specific objectives for the proper planning and sustainable development of the entire functional area of the local authority. If the Office of the Planning Regulator finds a plan is not in accordance with the proper planning and sustainable development of the area, the OPR will inform the Minister and may recommend the use of Ministerial powers to rectify the matter.

Source: Department of Communications, Climate Action and Environment (2020[18]), Project Ireland 2040, https://bit.ly/3ggT1iJ; Office of the Planning Regulator (2020[19]), The Planning System in Ireland, https://www.opr.ie/about/.

This emphasis on planning is translated in the budget process, where line ministries receive a five-year capital funding envelope, and can carry-over unspent funds up to 10% limit, subject to Parliamentary scrutiny.

Two funds were created to ensure sufficient funding to implement these plans

In 2018, Ireland established two funds to fund public investment by local authorities: the Urban Regeneration and Development Fund (EUR 2 billion) within the Department of Housing, Planning and Local Government, and the Rural Regeneration and Development Fund (EUR 1 billion) within the Department of Rural and Community Development. These funds are inspired by the EU structural funds' competitive bid process and matching requirements (Box 4.3) and are fully funded by the state budget. The differentiation between urban and rural funds allows LGs with different needs, size and administrative capacities to access funding, avoiding competition for funding between rural and urban areas and projects. Eligibility criteria for these funds ensure that all local authorities are entitled to apply to one of the two funds.

Importantly, the funds are not bounded by thematic or sectoral requirements and thus do not create conditions for *"policy follows funding"* effect.[23] On the contrary, the key evaluation criteria (Box 4.3) create incentives for Irish LGs to come up with complex and multi-dimensional and multi-sectoral projects, further strengthening their capacities. After the first call for tender in 2018-19, the key evaluation criteria were amended, considering what type of projects were submitted to encourage LGs and respond to their needs.

Irish LGs participating in these measures are required to co-finance at least 25% of the project. As municipal borrowing is somewhat restricted in Ireland (ceiling on the new annual borrowing), finding matching funds is sometimes a limiting factor. LGs in Ireland own land. When investment projects require land, LGs may provide the land as part of their contribution.[24] Otherwise, LGs rely on their own revenues

[23] The only constraint is that these funds should not finance projects which benefit from funding streams from line departments (e.g. housing related projects)

[24] In those cases, the value of the land provided is estimated and deducted from the matching contribution required from the LG.

from property taxes and commercial rates[25] as well as fund-raising from local communities and private donors to match their own contribution.

The evaluation process of the projects applying for these funds is sophisticated and no appeal is permitted. The submitted projects go through a thorough *ex-ante* evaluation process. LGs may request a feedback session in case of refusal. However, these are not systematic and are often replaced with better public communication of the key criteria. The performance review of the approved projects may also be conducted at any time throughout the implementation of the project. The finalised projects, moreover, are also subject to an *ex-post* assessment against the key criteria.

Box 4.3. Urban Regeneration and Development Fund (URDF) and Rural Regeneration and Development Fund (RRDF) eligibility criteria, evaluation, and assessment processes

The Urban Regeneration and Development Fund (URDF) and the Rural Regeneration and Development Fund (RRDF) are a competitive bid-based Exchequer-funded measures operating over a multi-annual period.

Projects submitted to the URDF are subject to a minimum funding request of EUR 2 million (EUR 10 million in metropolitan areas).

RRDF applications are separated into two categories, depending on the degree of preparation:

- *Category 1* proposals are large-scale capital projects with full planning and consents in place and are ready to commence. These projects are subject to a minimum funding request of EUR 500 000 and no maximum.
- *Category 2* proposals are projects that require support for further development to make them ready for Category 1 status. These projects are not subject to a minimum or maximum funding request.

Eligibility criteria: the applicants must provide at least 25% of total project value in matching contributions. For the RRDF, if half of this matching funding is from a community group, the fund provides 80% of total project value, instead of 75%.

Key evaluation criteria. Projects applying to this measure should demonstrate:

- *Capacity to deliver* on the objectives of different local, regional or sectoral development plans and strategies.
- *Collaboration* between different stakeholders.
- *Transformative potential*, capacity to deliver transformative change and act as a catalyst for increased activity in a rural area.
- *Additionality*, the project could not have taken place without the investment of the Fund and is not replacing investment which is already provided.
- *Value for Money*, the project will deliver outputs and outcomes, which will justify the investment.
- *Leveraging* of funding from the parties to the application, including philanthropic funders and/or the private sector where appropriate.
- *A significant and sustainable impact* on the social or economic development of rural communities.

[25] Commercial rates are a property based tax levied by local authorities on the occupiers of commercial or industrial properties (2018[44]).

- *Sustainability*, the capacity to deliver lasting benefits, which will outweigh the investment made and be in a position to achieve and maintain financial independence.

Project applications to both funds are subject to a thorough ex-ante assessment process. After the implementation, projects undergo a review process and ex-post evaluation.

Source: Department of Rural and Community Development (2019[20]), *Rural Regeneration and Development Fund: Information Booklet*, https://bit.ly/2X5PlHl; Department of Housing, Planning and Local Government (2020[21]), Urban Regeneration and Development Fund, https://bit.ly/2TzDhh1.

Centralised borrowing agency with explicit CG guarantee

The Housing Finance Agency Ireland (HFA) was established as a state-owned company in 1982 (Box 4.4). It provides loans at preferential rates to local authorities, voluntary housing sector and higher education institutions to finance housing related projects. The scope of possible projects has recently been increased, covering for example student accommodation, playgrounds, graveyards, access roads, pedestrian bridges, libraries, or swimming pools. The HFA also lends to local authorities for waste and environment capital project. The HFA offers Irish local authorities long-term fixed interest rates with 20-30 years maturities.

The HFA lends to local authorities at very competitive rates. The HFA raises its funds on the domestic and international capital markets, and its funding is explicitly guaranteed by the CG, allowing the HFA to borrow very cheaply. Moreover, the fact that Irish LGs cannot default[26] also acts as an implicit guarantee. The HFA does not aim to make a profit, it only adds a small margin onto its cost of funds to cover its administration costs.

Box 4.4. Housing Finance Agency

Housing Finance Agency plc is a company under the aegis of the Minister for Housing, Planning and Local Government of Ireland. It was established by the Housing Finance Agency Act, 1981 and incorporated in 1982. Its shares are owned by the Minister for Public Expenditure and Reform of Ireland.

The HFA's Board is appointed by the Minister for Housing, Planning and Local Government with the consent of the Minister for Public Expenditure and Reform. It has 12 members and is representative of such as local authority members and officials, the voluntary housing sector and senior public servants.

The HFA has a staff complement of 13.

Source: Housing Finance Agency (2020[22]), Building Social Housing, www.hfa.ie.

The HFA lending processes differ according to the institutional nature of the borrower. Municipalities must get the approval from the Department of Housing, Planning and Local Government before requesting a loan to the HFA. The Department is responsible for ensuring the quality of the investment project and its sustainability. The HFA only checks that municipalities have a valid council resolution and approval by the Department, and does not do any additional checks for municipal loans applications. The loan application process with the HFA is entirely paperless, implemented via specialised IT system and approval is provided

[26] Direct CG controls and transfers ensure no LG defaults.

online. According to the HFA, the seamless loan granting process resembles *an ATM-like* money withdrawal.

When providing loans to approved housing bodies (private institutions, which are not guaranteed by the state), the HFA follows very sophisticated credit assessment process and criteria. This assessment involves an examination of 20 stringent indicators related to the past (i.e. annual reports, financial accounts, reserves), present (i.e. corporate governance) and future (i.e. development plans: financial and strategic).

Bundling projects to use PPPs

PPPs are governed by a statutory framework, and supported by a national competence centre, the National Development Finance Agency. There are 29 PPP projects in operation or construction stage, with a total construction capital cost of EUR 5,177 million. An additional EUR 500 million has been earmarked for a further 3 project bundles. It is not unusual for several projects of the same nature are to be bundled together to reach a minimum size of EUR 100 million. All PPP projects should demonstrate–value for money compared to traditional procurement.

Summary of Ireland's framework for MFFFPI in the light of the analytical framework

Ireland is a clear example of a control based system for ensuring LG fiscal efficiency and sustainability (Table 4.1).

Table 4.1. The institutional framework of the Irish LG sector and availability of funding options[27]

Funding	Revenue and expenditure autonomy	Low	• LGs heavily rely on CG grants and subsidies, which represent around 52% of LG revenues. • Tax raising capacity is moderate – around 19% of total revenue. • LGs raise around 26% of total revenue through commercial rates (fees) (commercial water charges, rental income, parking charges and similar). • Very limited spending responsibilities, mainly in social protection and housing sectors.
	Public investment grants	High	• ESIF support has been decreasing after having benefited substantially during the Cohesion period. • In 2018, the CG created two competitive funds, which provide grants to LGs' public investment projects.
Fiscal discipline mechanisms	Fiscal rules	Low	• LGs are subject to the balanced budget rule on their operating budget (golden rule) calculated in accruals. • Deficit rule applied to LG sector as a whole not on individual municipalities.
	Direct controls	Extremely high	• LGs can only borrow from CG and are subject to an annual debt ceiling for new borrowing.
	Monitoring and enforcement mechanisms	Moderate	• Borrowing constraints and monitoring and enforcement mechanisms are less relevant in Ireland due to stringent controls from the CG. • The National Oversight and Auditing Commission for Local Governments oversees LG performance and examines the value for money in service delivery.
	Insolvency frameworks	Low	• None: direct CG controls and transfers ensure no LG defaults.
Financial instruments	Loans	Moderate	• Commercial debt is not allowed: LGs can only borrow from the state agencies. The Housing Finance Agency is a state agency from which municipalities borrow for housing related projects.
	Bonds	Moderate	• Municipalities are not allowed to issue bonds. • The Housing Funding Agency raises its funds on the domestic and international capital markets.
	PPPs and other alternative financing	Low	• LGs typically rely on CG funding and rarely engage in different types of financing. • Projects for PPPs are bundled together to achieve greater economies of scale (around EUR 100 million), but these are typically carried out at the CG level.
	Guarantees	High	• CG provides an explicit guarantee for LG borrowing.
Financial institutions	CG lending	High	• Municipalities can only borrow from CG agencies: National Treasury Management Agency and Housing Finance Agency.
	Public investment funds	High	• Two funds for public investment created in 2018 with CG funds: - Rural Regeneration and Development Fund. - Urban Regeneration and Development Fund. • Co-financing rate is 25%.
	LGFAs	Low	• Ireland does not have a LG funding agency (it has one CG-owned agency specialised in lending for housing).
PFM systems	Budgeting and reporting practices	High	• Budgets are prepared on accrual basis. • Budgeting is subject to distinct planning and financial reporting mechanisms. • Appraisal and evaluation mechanisms are well developed. • Predictability of future funds is high: five year envelope for capital budgets for Departments.
	Strategic planning practices	High	• Strategic planning practices are highly developed in Ireland. In the context of the Project Ireland 2040, the Ireland National Planning Framework (NPF) was established. It elaborates development strategies for regions, cities, towns and rural areas for the next decade.
	Administrative capacity	High	• Strong focus on administrative capacity building (especially, during the Cohesion period) for the execution of capital investments.
Multi-level governance	Vertical coordination and support mechanisms	High	• A dedicated ministry responsible for municipal affairs – Department of Housing, Planning and Local Government - co-ordinates planning and manages the funding of LGs in Ireland.
	Inter-municipal (horizontal) coordination and cooperation	Low	• There is no strong culture of municipal co-operation.

Good practices from Ireland

This case study highlights a number of good practices and conditions for success in the framework for budging and financing LG public investment:

- Strong PFM capacity of LGs, in particular for planning
- Very clear vertical coordination mechanism, with one department in the Department of Housing, Planning and Local Government responsible for all fiscal issues related to LGs.
- A comprehensive strategic planning framework, aligning plans from all levels of government
- “Funding follows the policy”
- Predictability of funding: five-year capital budgets for line ministries
- CG created funds to ensure funding to implement LG investment plans
- Centralised borrowing agency which raises its funds on domestic and international capital markets, with explicit CG guarantee

Interviewed institutions

The mission to Ireland took place on the 26-27 of February 2020. Additional discussions with relevant stakeholders were carried out via videoconferencing in March 2020.

Institutions interviewed
Department of Public Expenditure and Reform
Department of Rural & Community Development
Local Government Finance Unit, Department of Housing, Planning and Local Governments
Planning Programme Management Section, Department of Housing, Planning and Local Governments
ERDF Audit Authority
Housing Finance Agency
Kilkenny City Council
Waterford City Council

[27] Please note the framework refers to the importance (high/medium/low) of each of the elements in the national system, not its quality nor stringency.

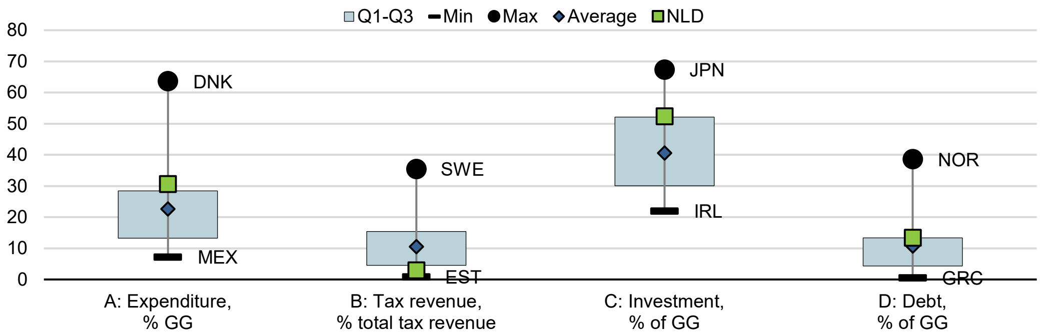
5 Netherlands

This case study of the Netherlands is preliminary and is still being completed. The case study first presents a brief overview of the role of LGs in the Netherlands, then describes the main characteristics of Netherlands' funding and financing framework for LG public investment. This is followed by a summary table presenting the different elements of Netherlands' case, following the analytical framework presented in section one, and the last section highlights good practices identified in the Netherlands.

Overview of LGs' role in the Netherlands

The Netherlands is a moderately decentralised unitary country with LG expenditure representing 30% of total general government expenditure. The Netherlands has two tires of subnational government: provinces[28] and municipalities. Municipalities (LGs) are responsible for most of the SNG expenditure and debt, while provinces' main role consists of the supervision of municipal financial management, and spatial planning. LGs in the Netherlands are of particular importance in terms of public investment carrying out about 52% of all public investments.

Figure 5.1. The Netherlands: LG expenditure, investment and debt as a share of GG and LG tax revenues as a share of total tax revenues, 2018



Note: A: data unavailable for Australia, Chile, Japan, South Korea, Turkey and USA; B: data unavailable for Australia, Japan, Mexico; C: Gross capital formation is used as a proxy for investment (GP5P), data unavailable for Australia, Chile, USA, data for New Zealand refers to 2017; D: data unavailable for Israel, Australia, Chile, Iceland, South Korea, Mexico, USA.

Source: A: OECD (2019[1]), OECD Fiscal Decentralisation Database, https://www.oecd.org/ctp/federalism/fiscal-decentralisation-database.htm. B: OECD (2018[6]), Global Revenue Statistics, https://www.oecd.org/tax/tax-policy/global-revenue-statistics-database.htm; C: Calculations based on OECD (2019[2]), National Accounts: Government deficit/surplus, revenue, expenditure and main aggregates, https://stats.oecd.org/Index.aspx?DataSetCode=SNA_TABLE12, D: OECD (2019[3]), Government at a Glance: Public Finance and Economics, https://www.oecd.org/gov/government-at-a-glance-2019-database.htm.

28 Provinces in the Netherlands corresponds to the regional level rather than state level as in the case of Canada.

Box 5.1. Territorial organisation and recent LG reforms in the Netherlands

Municipal and provincial autonomy is anchored in the 1848 Dutch Constitution. The Netherlands has a two-tier local government system with 12 provinces and 352 municipalities as of 2021. Moreover, there are 22 water authorities (*waterschappen*) responsible for water-related affairs in the Netherlands.

Territorial organisation		Population and geography	
Number of tiers of government	2	Area (km2)	37 378
Number of LGs	352	Population (1000)	17 181
Average LG size (inhabitants)	48 397	Population growth	0.3
		Density (inhab/km2)	459.7
		Urban population (%)	91.1
		Population in capital city (% of total pop)	6.6

Notable reforms related to LGs in the Netherlands:

- 2002: Act of "dualisation" separating composition, functions and powers of the deliberative council and the executive of LGs.
- 2007: a decentralisation programme transferred new responsibilities to provinces and municipalities.
- Since 2015: Start of a new decentralisation process with large responsibilities to be transferred to municipalities in the social sector (youth health, long-term care and employment support for young disabled people). Creation of a new fund for social affairs to accompany the decentralisation in the social sector; revitalising and strengthening the role of the provinces with more focused powers in regional planning, economic development and coordination.
- Gradual but significant drop in the number of municipalities, from 913 in 1970, to 443 in 2007, 380 in January 2018 and even 355 in January 2019.

Source: OECD (2019[14]), Making Decentralisation Work: A Handbook for Policy-Makers, OECD Multi-level Governance Studies, OECD Publishing, Paris. https://doi.org/10.1787/g2g9faa7-en.

The Dutch framework for municipal funding and financing of public investment

LGs rely mainly on CG general purpose grants, expenditure follow the "local if possible, central if necessary" principle

Dutch SNGs substantially rely on CG transfers, which represent over 74% of total SNG revenues (OECD, 2019[3]). The grant system is rather complex, and municipalities and provinces receive both general purpose grants (47% of total revenue) and earmarked grants (around 12% of total revenue), which are subject to checks by the Ministry of Interior (VNG, 2018[23]). The general grants are redistributed as lump-sum payments based on a well-established formula-based equalisation system from a Municipality Fund (*Gemeentefonds*) and Province Fund.

Local tax-raising capacity in the Netherlands is relatively weak and represents around 17% of total LG income and 2.7% of total tax revenue (OECD, 2019[3]). Property taxation constitutes the largest share of local tax revenue. Municipalities have a right to set their property tax within pre-defined limits regarding the subjects of taxation. Dutch LGs can also collect administrative charges and fees, but these can only cover the costs of providing the associated services (LGs cannot make a profit of these fees and charges).

On the expenditure side, in 2004, the principle of subsidiarity "local if possible, central if necessary" was anchored in the Inter-Governmental Code. This code is meant as an informal agreement between the CG and SNGs to organise and streamline inter-governmental relations (VNG, 2018[23]). In the last decades, there has been a tendency to transfer services to the lower levels of government (e.g. social services since 2015). However, these changes are sometimes not accompanied by sufficient funding, thus negatively affect reserves of municipalities (Raffer, 2018[24]). Moreover, the Dutch municipalities are under the direct scrutiny of provinces and can be bailed out (in a form of municipal grants from Municipal Fund) in case of severe deterioration of financial conditions. However, this is exercised rarely.

Dutch municipalities responsible for almost half of public investment, however, CG directly funds public investments of national importance

Dutch LGs play an important role in public investment: LGs are responsible for about 52% public investment. Local investments are mainly funded by the CG grants from line ministries and own resources (rents from municipal land, local taxes and similar). To finance smaller scale infrastructure investments (e.g. small local roads) municipalities are free to borrow but are subject to a balanced budget rule and some additional borrowing limitations.

The CG directly finances a large share of public investments (e.g. large roads, investments of national importance), which otherwise could be too constraining to finance from municipal budgets and could lead to financial inefficiencies. While the CG government plays an important role in deciding upon public investments, the Dutch municipalities and provinces can participate in the elaboration of public investment strategies (Box 5.2).

Box 5.2. The Multi-Year Programme for Infrastructure, Spatial Planning and Transport in the Netherlands

In the Netherlands, the Multi-Year Plan for Infrastructure, Spatial Planning and Transport (MIRT) is an investment programme set up by the Ministry of Infrastructure and Water Management, with the objective to improve the coherence among investments across several areas: spatial planning, economic development, mobility and liveability. In addition, the MIRT is organised in “Areas Agendas” (to be referred to in the future as “Regional Agendas”), where cooperation among national, provincial and municipal governments and third sector actors can take place.

Any Dutch Ministry and regional partners (provinces, municipalities, transport regions, or district water boards) can launch and/or participate in MIRT programmes. Each submitted project must pass through a MIRT Consultation Committee, guided by regional agendas, before being finalised in a collective agreement. This programme is funded through two funds emanating from the Ministry: an Infrastructure Fund, and a Delta Fund for water projects. The MIRT also set a framework with rules and procedures to access national investment funding in order to guide project proposals and project selections (Dutch Ministry of Infrastructure and Water Management, 2018[25]; Government of the Netherlands, 2019[26]).

Source: OECD (2020[27]), OECD Multi-level Governance Review. The Future of Regional Development and Investment in Wales.

A wide-spread practice of horizontal cooperation for cost-efficiency and improved quality of service delivery

The distinctive feature of the Dutch system is a long tradition of inter-municipal cooperation, which dates back to the 19th century. The current system is governed by the Joint Regulations Act (WGR Act), which came into force in 1985 and was amended several times to increase the transparency and efficiency of the system.

In the Netherlands, there are over 900 inter-municipal cooperation structures (The Ministry of Interior and Kingdom Relations, 2020[1])indicating that horizontal cooperation is a wide-spread practice. Many formal and informal coordination arrangements emerge not only between municipalities but also with water boards, provinces, and CG. Moreover, active citizen participation and involvement is encouraged (Brand, 2016[29]). The increase of different inter-municipal arrangements over time is mainly driven by the CG, increasingly transferring responsibilities to the lower levels of government (OECD, 2014[28]). Such a wide-spread practice of horizontal cooperation positively contributed to the quality and cost of the services provided by municipalities (Brand, 2016[29]).

Most of these are cooperation arrangements are voluntary. However, municipal cooperation is mandatory for some arrangements. Most of the current structures relate to fire-fighting, ambulance services, waste disposal, disaster contingency plans and social services (OECD, 2014[28]). Municipalities sometimes choose to engage not only in joint funding but also in joint levy of taxes (Brand, 2016[29]).

Tight balanced budget rule (zero deficit) and additional borrowing constraints to limit interest rate exposure risk

The Dutch municipalities are subject to a balanced budget rule, which is anchored in Municipalities Act. Moreover, since 2013, Dutch SNGs must make similar efforts as the CG to comply multi-annually with the European budget rules in particular the EMU deficit/balance and the EMU debt (OECD, 2019[1]). LG must prepare multi-year budgets, for the current fiscal year and three following years. LG budgets must include a special section on budgetary risks which may significantly affect the financial position of a municipality. More precisely, interest rate exposure.

While borrowing is not subject to direct controls by CG or provinces, to limit the interest rate change risk, the Dutch municipalities are subject to borrowing limitation, which relate to the term structure of government debt and not the total debt levels. Two legal restrictions on municipal borrowing exist:

- ***The short-term debt ceiling*** (*kasgeldlimiet*): net short-term debt shall not exceed 8.5% of budgeted expenditure for each quarter of a fiscal year.
- ***The long-term debt ceiling*** (*renterisiconorm*): long-term debt for which the interest rate is subject to change in a given year (because it reaches maturity, or because the interest rate is not fixed) shall not exceed 20% of budgeted spending.

Moreover, engagement in financial speculation with public funds is vastly restricted. To limit financial risks, derivative contracts are allowed only with AA-rated institutions within EU, and speculative positions with derivatives are not permitted.

Negative general reserve must be offset, but municipalities have discretion over surpluses

Provinces, which supervise Dutch municipalities, may authorise deficit. Since 2013, Dutch local authorities are subject to an annual deficit limit, which aims to limit risks of government exceeding EMU deficit limit of 3% of GDP, which happened in 2003 due to large deficits of LGs. An aggregate deficit limit of 0.5% of GDP is applied to local authorities: 0.38% for municipalities, 0.07% for provinces and 0.05% for the water boards

(OECD, 2019[1]). However, these limits are hardly binding as they are calculated on cash accounting principles, and municipalities use income and expense system.

A negative general reserve (deficit) is nonetheless not allowed to persist. Municipalities must adjust their budgets within four years to make it positive again or otherwise they would be subject of direct supervision by provinces (below). In the case of surpluses, the municipal council has the discretion to decide whether to keep it in the reserve as rainy day funds, spend on future investments or satisfy more immediate financial needs. The surpluses, however, must be kept on the Treasury account of CG, not on individual municipalities bank account (Raffer, 2018[24]).

Vertical coordination and supervision by provinces

In the Netherlands, municipalities are not under the direct scrutiny of the Ministry of Interior. Instead, municipalities are supervised by provinces, which, in turn, are supervised by the Ministry of Interior.

Provinces are assigned the task of supervising municipal finances (vertical supervision) for the municipalities within its own province. The financial supervision is based on the principles of “a premise of trust in the own responsibility of municipalities by staying alert to financial problems’ and “checks on information quality’. The main focus is on retrospective supervision, also referred to as repressive supervision. Provinces may signal to the council and alderman (the daily management) to make the necessary adjustments in their budgets. However, provinces cannot impose measures on Dutch municipalities unless they fall in one of the three situations when direct supervision by provinces can be imposed:

- Imperative financial supervision may be imposed in the event of a negative deficit in the year t coupled with the inability to balance the budget over the next three years (t+3).
- Optional financial supervision in case of non-compliance with the statutory submission periods for the budget and accounts. The municipal supervisor does not approve municipal budget but rather checks the financial information provided and its compliance with the Municipalities Act, which stipulates specific requirements for financial documentation.
- Automatic supervision in case of municipal amalgamation to prevent municipalities from taking financial decisions, which could negatively affect the financial situation of the new amalgamation.

A bailout system for municipalities in financial difficulties

The Dutch municipalities cannot declare bankruptcy. Nonetheless, there is a well-established procedure for municipalities in financial distress, which limits the risks of defaulting on debts (Ministry of Finance, 2019[31]). The Financial Relation Act (Section 12) lays out special measures for CG intervention and determines certain criteria municipalities must fulfil to be eligible for such procedure.

Importantly, the financial difficulties of an individual municipality are covered collectively through a supplementary grant, often referred to as "Section 12 grant" or "bailout grant". These special grants are paid to municipalities from the Municipal Fund, from which general purpose grants are paid out. Hence, the incidence falls not on the CG budget, but it proportionately reduces grants allocated to other municipalities.

Municipalities wishing to apply to the bailout procedure must fulfil certain criteria and must comply with the rules for the whole period covered by the bailout procedure. Municipalities must apply themselves to the procedure (Box 5.3), and CG decides whether municipalities qualify and should be allocated supplementary grant.

Criteria for the bailout procedure:

- A municipality must have a significant and structural deficit, which is larger than 2% of the sum of the general purpose grant and the local property tax capacity (calculated as tax revenues given a certain standard tax rate). Structural deficit refers to a situation when a municipality is unable to balance its budget in a given year and a forecast of budget balance for the next three years is negative.
- A municipality must have above average local property tax rate. Since 2002, this is defined as 120% higher than the national average.

In 1997 a new formula-based grant scheme equalisation system was introduced and the bailout system is used very rarely.

Box 5.3. The municipal bailout application procedure

Application for a bailout in year t takes the following steps:

- Before the 1st of December in year t-1, the municipality has to notify the province and send a request to the responsible central government ministries on the basis of their proposed budget.
- The province then has 2.5 months to investigate the financial situation of the municipality and write a report which has to be sent to the relevant ministries and the municipality before the 15th of February.
- An inspector of the Ministry of the Interior starts an investigation and checks whether the municipality fulfils all requirements. The inspector will also report any missing yet necessary information for the full report. He/She will send the ministry and the municipality a preliminary report by the 1st of March and the full report before the 1st of December of year t.
- Both the municipality and the province have the opportunity to react to the report made by the inspector before the 1st of February in the year t+1.
- The responsible ministers will then decide whether or not to supply a bailout grant by the 1st of June of year t+1.

A municipality applying for bailout is obliged to do everything within its power to restore financial health. In practice, the local government loses its budgetary autonomy. It cannot take decisions that lead, directly or indirectly, to increased spending or reduced revenues, except when this prohibition would lead to unacceptable problems. Whether such an exception can be made is decided by the central government. The municipality has to formulate a cut-back budget, detailing which services will be cut and by how much. This process is overseen by an Inspector from the Ministry of the Interior.

Source: Ministry of Interior (2019[31]), Submission to the Fiscal Rules questionnaire of the OECD Fiscal Network.

BNG Bank – municipal bank providing an affordable financing option

The Municipal Bank of the Netherlands (BNG Bank) is a funding agency established by the Dutch Association of Municipalities in 1914 in order to help municipalities' access credit markets. In addition to the BNG Bank, the water boards can borrow from the NWB Bank (Dutch Water Board Bank), which is similar to the BNG Bank, but smaller.

Half of the bank's share capital is held by the CG and the other half by municipalities, provinces and a water board.

The BNG provides loans to housing associations, healthcare institutions and public utilities under different conditions than for municipalities (Box 5.4).

Box 5.4. Different clients of the BNG Bank

Municipalities

Dutch municipalities are able to fulfil their financial obligations entirely and at all times. The financial relationship between central and local government in The Netherlands is structured in such a way, that the credit quality of Dutch municipalities is equal to that of the State of the Netherlands. The State of the Netherlands is rated Aaa by Moody's (stable outlook), AAA by Standard & Poor's (stable outlook) and AAA by Fitch (stable outlook). Dutch municipalities are not rated individually. Loans to Dutch municipalities are 0% risk weighted by the Dutch central bank.

Housing Associations

Liabilities of housing associations are supported by a Social Housing Guarantee Fund, Waarborgfonds Sociale Woningbouw (WSW). This fund is ultimately backed by the State of the Netherlands and the municipalities and rated Aaa by Moody's and AAA by Standard & Poor's. Financial supervision of this sector is the responsibility of the Autoriteit woningcorporaties (AW).. WSW guaranteed loans are 0% risk weighted by the Dutch central bank.

Healthcare Institutions

Liabilities of healthcare institutions are secured by a Healthcare Guarantee Fund, Waarborgfonds voor de zorgsector (WfZ). This fund is ultimately backed by the State of the Netherlands and rated AAA by Standard & Poor's. The Dutch central bank has given WfZ guaranteed loans a 0% risk weighting.

Public Utilities

Dutch public utilities, owned by municipalities and provinces, still enjoy strong domestic market positions resulting in a high credit quality. Furthermore, the major clients of BNG Bank in this sector have an external rating, which reflect their creditworthiness. The loans to public utilities carry a risk weighting for capital adequacy purposes.

Source: BNG Bank (2019[32]), BNG Bank lending.

Summary of the Netherland's framework for MFFPI in the light of the analytical framework

The Netherlands are a clear example of rules-based system for ensuring LG fiscal efficiency and sustainability.

Table 5.1. The institutional framework of the Dutch LG sector and availability of funding options[29]

Funding	Revenue and expenditure autonomy	**Moderate**	• Dutch SNGs substantially rely on CG transfers, which represent over 74% of LG revenues. • Tax raising capacity is relatively low – 10% of LG revenue. Municipalities have a right to set a property tax rate within pre-defined limits. Property taxation constitutes the largest share of local tax revenue. • Several grant funds exist which are redistributed based on an equalization system. • Moderate discretion over expenditures. Municipalities receive earmarked grants (around 12% of revenues) which are subject to checks related to the objectives and conformity with rules.
	Public investment grants	**High**	• ESIF support is low. • Most of the local investments are directly financed by line ministries through grants.
Fiscal discipline mechanisms	Fiscal rules	**High**	• Structural balanced budget rule (on both operating and capital budgets and off-budget funds) calculated in modified cash basis. • Multi-annual budget balance requirement – similar to that of CG. • Borrowing limits on short and long term borrowing to limit risks of an interest rate change.
	Direct controls	**Low**	• No CG direct controls with regards to borrowing.
	Monitoring and enforcement mechanisms	**High**	• Provinces conduct *ex-post* compliance with fiscal rules, checks and monitors other financial sustainability indicators. It may put municipalities in financial distress under direct supervision. • Bailout mechanisms for municipalities in financial distress exist. However, these are used rarely due to sound fiscal stance of municipalities and well-established equalisation system.
	Insolvency frameworks	**Low**	• Municipal bankruptcies are not allowed.
Financial instruments	Loans	**High**	• Dutch municipalities heavily rely on loans, most of which are from the Municipal Bank of the Netherlands (BNG Bank).
	Bonds		
	PPPs and other alternative financing	**Low**	• Municipalities rarely engage in alternative financing for public investment practices.
	Guarantees		
Financial institutions	CG lending		
	Public investment funds	**Low**	• PI funds are not prevalent in the Netherlands.
	LGFAs	**Moderate**	• Netherlands has a specialised public financial institution - the Municipal Bank of the Netherlands (BNG Bank). • Half of the bank's capital share is held by the CG and the other half by municipalities, provinces and a water board. •
PFM systems	Budgeting and reporting practices	**High**	• Municipalities prepare and approve budgets for four years using income and expense system. • High level of budgetary transparency. • Medium-term perspective in budget preparation is well established.
	Strategic planning practices	**High**	• Natherlands has an elaborate investment planning programme (the Multi-Year Plan for Infrastructure, Spatial Planning and Transport (MIRT)). • Any Ministry or local or regional authority can launch or participate in the programme and is finalised by collective agreements.
	Administrative capacity	**Moderate**	• Dutch SNG sector employs a higher share of civil servants than CG (166 000 and 115 000 respectively).
Multi-level governance	Vertical coordination and support mechanisms	**High**	• Well-established vertical coordination mechanism, where provinces supervise municipalities and CG, namely, the Ministry of Interior supervises provinces
	Inter-municipal (horizontal) coordination and cooperation	**High**	• Municipalities voluntarily engage in joint structures to achieve greater scale. Over 900 horizontal cooperation structures exist.

Good practices from the Netherlands

This case study highlights a number of good practices and conditions for success in the framework for budging and financing LG public investment:

- Large investments (e.g. those of national importance) are performed at the CG level to limit financial pressures to municipal budgets.
- Wide-spread horizontal cooperation
- A strong vertical supervision coupled with a special bail-out mechanism for municipalities in financial distress.
- Well-developed national strategic planning practices and possibility for municipalities and provinces to participate in elaboration of these strategies.
- A high level of predictability of funding. CG transfers are formally agreed for four years and cannot be changed easily.In practice, the predictability of revenues received from the Municipality Fund and Provincial Fund stretch beyond electoral cycle.
- A specialized publicly owned lending agency, which raises its funds on financial markets and provides favorable rates by pooling municipal risk.

Interviewed institutions

The mission to the Netherlands took place virtually between the 10 July and the 24 July 2020.

Institutions interviewed
CPB Netherlands Bureau for Economic Policy Analysis
Former Secretary General of the Ministry of Finance
University of Groningen

[29] Please note the framework refers to the importance (high/medium/low) of each of the elements in the national system, not its quality nor stringency.

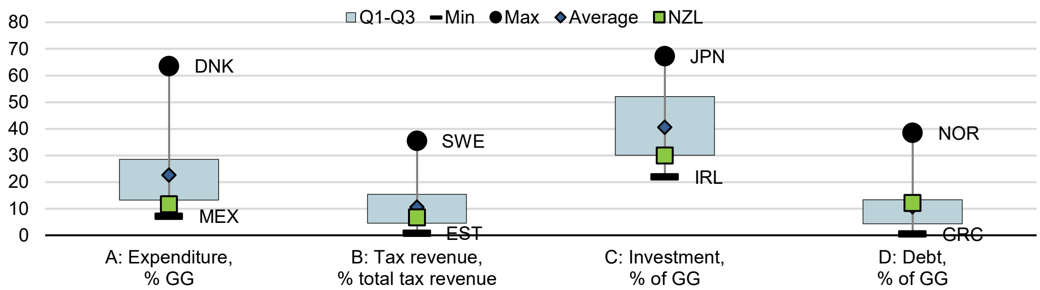
6 New Zealand

This case study first presents a brief overview of the role of LGs in New Zealand, then describes the main characteristics of New Zealand's funding and financing framework for LG public investment. This is followed by a summary table presenting the different elements of New Zealand's case, following the analytical framework presented in section one, and the last section highlights good practices identified in New Zealand.

Overview of LG's role in New Zealand

The New Zealand LG sector is smaller than in most OECD countries in terms of spending ratio (Figure 6.1), but within their functions, LGs are extremely free to raise taxes (property tax represents 50% of their revenues), spend or borrow. Beyond requiring that councils manage their finances prudently and operate a balanced budget central government imposed fiscal rules are not prescriptive. However, market-based controls, in particular credit ratings, play a major role in the New Zealand system. The Local Government Funding Agency (LGFA) holds about 90% of LGs debts, and *de facto* imposes a very strict debt ceiling.

Figure 6.1. New Zealand: LG expenditure, investment and debt as a share of GG and LG tax revenues as a share of total tax revenues, 2018



Note: A: data unavailable for Australia, Chile, Japan, South Korea, Turkey and USA; B: data unavailable for Australia, Japan, Mexico; C: Gross capital formation is used as a proxy for investment (GP5P), data unavailable for Australia, Chile, USA, data for New Zealand refers to 2017; D: data unavailable for Israel, Australia, Chile, Iceland, South Korea, Mexico, USA.
Source: A: OECD (2019[1]), OECD Fiscal Decentralisation Database, https://www.oecd.org/ctp/federalism/fiscal-decentralisation-database.htm. B: OECD (2018[6]), Global Revenue Statistics, https://www.oecd.org/tax/tax-policy/global-revenue-statistics-database.htm; C: Calculations based on OECD (2019[2]), National Accounts: Government deficit/surplus, revenue, expenditure and main aggregates, https://stats.oecd.org/Index.aspx?DataSetCode=SNA_TABLE12, D: OECD (2019[3]), Government at a Glance: Public Finance and Economics, https://www.oecd.org/gov/government-at-a-glance-2019-database.htm.

LGs in New Zealand have a smaller policy role than in most OECD countries, as they are not responsible for health, social protection or education. However, they do play a significant role in public investment. In 2016, one-third of LGs' expenditure was dedicated to investment (roads, transport and utilities – water in particular), which represented 1.3% of GDP (OECD, 2019[1]). LGs provide cultural and recreational facilities and services and are responsible for local regulatory services. However, due to their lack of responsibility on social issues, LG councils are often perceived as a technical body for providing key infrastructure to citizens.

Box 6.1. Territorial organisation and recent LG reforms in New Zealand

New Zealand is a unitary state with two tiers of local governments: 16 regions, and 67 territorial authorities. Regions are governed by regional councils (11) and territorial authorities by city councils (12) and district councils (53), the Auckland Council and the Chatham Island Council. There are five "unitary authorities" which combine both regional council and regional authorities functions. Councils are directly elected by the residents of that region, district or city.

Territorial organisation		Population and geography	
Number of tiers of government	2	Area (km2)	267 710
Number of LGs	67	Population (1000)	4 820
Average LG size (inhabitants)	224 742	Population growth	1.1
		Density (inhab/km2)	18
		Urban population (%)	86.5
		Population in capital city (% of total pop)	8.5

Notable reforms related to LGs in New Zealand:

- 1989: Local Government reform, monitored by an independent Local Government Commission, consisting in a large restructuring of LGs and special-purpose bodies, by reducing significantly the number of local authorities, creating regional councils and allocating functions.
- 2002: Local Government Act introduced a principle-based framework for local authorities which increased their autonomy and responsiveness by providing them with power of general competency and a broader purpose to promote well-being.
- 2012: Local Government Act implemented the Government's the Better Local Government programme by setting fiscal benchmarks and clarifying Ministerial intervention powers.
- 2018: Productivity Commission to investigate Local Government funding and financing.

Source: OECD (2019[14]), Making Decentralisation Work: A Handbook for Policy-Makers, https://doi.org/10.1787/g2g9faa7-en.

The New Zealand framework for municipal funding and financing of public investment

LGs have a high revenue and spending autonomy within limited scope

LGs in New Zealand are accountable to and largely funded by their own communities. Property tax (called "rates" in New Zealand) represents about half of LG revenues (New Zealand Productivity Commission, 2019[33]). This is seen as a very stable and predictable source or revenues, as property taxes are not affected by the level of economic activity or property market, and councils have broad powers to tax properties in their jurisdiction: there is no upper limit on rates income, and the property tax collection ranks ahead of other claimants (including other taxes and mortgages).[30]

Other sources of revenues include grants from the CG (mainly to finance road infrastructure and public transport services, which have grown substantially over recent years as a response both to transport congestion and to climate change.) (about 14% of LG revenues), sales and user charges (about 25% of LG revenues), development contributions (i.e. charges levied on developers to recover the portion of new infrastructure that is related to growth) (about 4% of LG revenues), or interests and dividends from LG owned enterprises (such as ports, airports, forests, farms, etc.) (about 8% of LG revenues).

Reliance on services fees are quite strong and there are plans to further increase them (for example in the water sector[31]). This is coherent with New Zealand's focus on the "benefit principle", which states that "those who benefit from, or cause the need for, a service should pay its costs. It implies that user charges or targeted rates (property taxes) should be used wherever it is possible and efficient to do so"[32] (New Zealand Productivity Commission, 2019[33]). However, borrowing is justified to finance public investment, as it enables the cost of assets to be matched with their benefits over their life. This promotes intergenerational equity, since those who benefit from the infrastructure contribute to its cost (New Zealand Productivity Commission, 2019[33]).

There is little equalisation in the system. Only on local road infrastructure financing, the CG provides a matching participation, which ranges from 50% to 75% of the cost of the project depending on the financial strength of the council. On the expenditure side, councils have "power of general competence", meaning they have the ability to choose the activities they understand to fulfil their statutory role and how they should undertake them, subject to public consultation.

Table 6.1. New Zealand's Local Governments' financial prudence benchmarks

Benchmark	A local authority meets the benchmark if:
Property tax (rates) affordability)	• Actual or planned property tax income for the year ≤ quantified limits on property tax income set by the authority in its financial strategy. • Actual or planned property tax increases for the year ≤ quantified limits on property taxes increases set by the authority in its financial strategy.
Debt affordability	Actual or planned borrowing for the year is within the quantified limits on borrowing set by the authority in its financial strategy
Balanced budget	Revenue for the year exceeds operating expenses
Essential services	Capital expenditure on network services for the year ≥ depreciation on the network services
Debt servicing	Yearly borrowing costs ≤ 10% of its revenues (15% for high-growth LGs)
Debt control	Actual net debt at the end of the year is ≤ planned net debt
Operations con trol	Actual net cashflow from operations for the year ≥ planned net cashflows from operations

Source: Local Government, (2014[34]), Financial Reporting and Prudence Regulations, quoted in New Zealand Productivity Commission (2019[33]), Local Government funding and financing, Final paper.

[30] However, a key concern about the strong reliance on property tax, is that it creates few incentives for councils to pursue economic growth and accommodate population growth. Indeed, new influx of population and firms generate costs for local governments, which need to provide support infrastructure such as roads, water or public transportation. But while such development would somewhat increase local property tax collection, most of the benefits it would generate would be increases in the CG-collected taxes (personal income tax, VAT, business taxes, etc.).

[31] New Zealand is currently planning a reform of water services delivery. However, it is not clear whether that will lead to different forms of charging.

[32] Ideally taking into account not just direct benefits, but also indirect and non-monetary community benefits.

Financial management, planning, public consultation and transparency are very strong

The institutional framework of New Zealand is often praised for its high level of quality, predictability and transparency.

New Zealand councils are required by the Local Government Act (2002) to provide financial strategies quantifying limits on the property tax rates, and to set prudent debt limits in consultation with their citizens.[33] The Office of the Auditor General ensures that councils accurately report against these self-established prudential benchmarks (Table 6.1).

The Local Government Act sets out a range of planning instruments relating to the provision of infrastructure. These include a 30 year infrastructure strategy, 10 years plans of activities and services, related to a financial strategy, and annual plans and reports (Table 6.2).

Table 6.2. Local Government Planning requirements in New Zealand

Requirement	Main purpose
Long-term plan and financial strategy	To plan activities and services provision over a timeframe of at least 10 years. As part of the Long-term Plans, LGs must prepare and adopt a financial strategy. The strategy's purpose is to facilitate prudent financial management, and to provide transparency about the effect of funding and expenditure proposals on property tax rates, debt and investments.
Infrastructure strategy	To set, over at least 30 years, the LG's approach to the development of new assets and the management of existing assets.
Asset management plans	To manage infrastructure assets in a way that meet required levels of service for current and future users
Annual Plan and Annual Report	To set out and report on planned activities, revenue and expenditure for a financial year

Source: New Zealand Productivity Commission (2018[35]), Local Government funding and financing, Issues paper.

In addition, Local Government New Zealand (the LG association) has recently introduced the "CouncilMARK Programme": a council improvement and evaluation framework which aims to improve the public's knowledge of the work councils are doing in their communities and to support individual councils further improve the service and value they provide (Box 6.2).

Government-imposed fiscal rules are very light

In 1996, a balanced budget rule was introduced, but it only applies to operating expenditure. LGs in New Zealand use accrual accounting, and the depreciation of their assets is included in the operating expenditure (at replacement cost and not historical costs). Depreciation thus represent about 25% of operating expenditure, which should be used to finance new investments.[34] The balanced budget rule is supervised by the Auditor General who oversees LGs' accounts. In some cases it can be lifted, if the LG's council can justify that it is economically sound to do so (for example if a large share of the expenditure consists on depreciation of assets).

[33] The most common indicators used to set debt limits are: interest payments as a share of total revenues, interest payments as a share of total property tax income and total debt as a share of total revenue

[34] "However, the Office of the Auditor General identified that over the past five years, asset reinvestment for most LGs has been less than 100% of depreciation. In 2016/17, there was 28 LGs whose renewals expenditure was less than 60% of depreciation. This may suggest that either: councils are opting to defer the replacement of assets; depreciation is too high; or funds accumulated from depreciation are being spent on other items. Over-accounting for depreciation has implications for inter-generational equity because it means current generations pay more for future renewals" (New Zealand Productivity Commission, 2019[33]).

Box 6.2. CouncilMARK Programme

The CouncilMARK™ local government excellence programme is a system designed to demonstrate and improve the value and services of councils by measuring indicators across four priority areas: governance, leadership and strategy; financial decision-making and transparency; service delivery and asset management; and communicating and engaging with the public and business. Participation in the programme is voluntary, but there is strong peer pressure to do so. Thirty councils have already signed up to the programme.

Participating councils are assessed by independent experts every three years and given an overall rating from triple AAA to C. In addition to that overall rating, councils are given a specific grading for each of the four priority areas. These priority gradings range as follows: exemplary > stand out > performing well > better than competent > competent > variable > areas for improvement > underperforming > struggling.

Assessment reports are public and contain recommendations for improving specific elements. CouncilMARK also publishes best practice case studies which present useful examples to other councils.

Source: CouncilMARK (2020[36]), The Programme, https://councilmark.co.nz/.

LGs are free to borrow as they please, without need for an approval from CG. However, if a LG faces financial difficulties, the CG has the capacity to temporarily replace the administration of the Council with appointed officials (usually consultants or retired local government chief executives, never government officials) until the problem is solved. Such a procedure is quite rare, but has happened two or three times in the last twenty years. The Local Government Act of 2002 states explicitly that the CG does not guarantee LG debts.

Fiscal discipline is however very strict, driven by market forces, in particular credit rating agencies and the Local Government Funding Agency

LGFA provides about 90% of LG loans, and de facto imposes a strict (though high) debt ceiling

In practice, the most binding fiscal rule in New Zealand is the debt ceiling of net debt to revenue ratio below 250%. This is not a fiscal rule set in law or constitution, but a limit imposed by the Local Government Funding Agency (LGFA) to access its loans, and therefore a freely and collectively accepted by LGs.[35]

The LGFA was created in 2011 and started operating in 2012. It is a publicly owned financial institution very similar to the KommuneKredit in Denmark or the MuniFin in Finland (Box 6.3). As its Nordic peers, it issues debt and bonds on national and international markets and lends to LGs charging only a small margin to cover administration fees and dividends to its shareholders. It is guaranteed by all shareholders (except the CG) and all LGs which have outstanding loans above NZ$20 million.

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[35] However, on the 30 June 2020, the shareholders of the LGFA approved the temporary lifting of this cap, in response to the COVID-19 pandemic. The LGFA amended the net debt to total revenue ceiling to 250% for the financial year ending 30 June 2020, 300% for the financial years ending 30 June 2021 and 2022, and for each of the following years, a decrease of 5% until a limit of 280% which will apply for and from the financial year ending 30 June 2026. https://www.lgfa.co.nz/about-lgfa/lgfa-news/shareholders-approve-change-to-lgfa-foundation-policy-covenant

Box 6.3. Main characteristics of LGFA

Primary objective: to optimise the debt funding terms and conditions for participating councils

- Savings in interest costs;
- Availability of longer term borrowings;
- Enhancing certainty of access to debt markets.

Additional objectives:

- Operate with a view to make a profit sufficient to pay a dividend;
- Provide at least 50% of aggregate long-term funding for participating councils;
- Ensure products and services are delivered at cost in line with budget;
- Maintain LGFA's credit rating equal to the New Zealand Government sovereign rating;
- Achieve financial forecasts;
- Meet or exceed performance targets;
- Comply with Treasury policy.

Shareholders	Governance	Borrowers	Guarantors	Liquidity	Capital structure
• CG holds 20% of shares; • 30 councils hold 80% of shares; • Can only sell shares to CG or councils.	• Board of six directors with 5 independent and 1 non-independent; • Bonds listed on NZX, i.e. under listing rules; • Supervised by Independent Trustee; • Issue of securities to the public under the Financial Markets Conduct Act and regulated by Financial Markets Authority • Audited by CG under the Office of the Auditor General (OAG) and Audit NZ.	• 67 council borrowers; • 90% market share; • Under Local Government Act 2002 councils must act prudently: implies must run balanced operating surplus and only borrow for capital expenditure; • Councils borrow secured against rates (property taxes); • Must meet LGFA financial covenants.	• There are 53 Guarantors of LGFA; • Guarantors comprise: - All shareholders except NZ government; - Any non-shareholder who may borrow more than NZ$20 million. • Security granted by each of the Guarantors is over their rates (property tax) income; • Guarantors cannot exit until: - Repaid all their borrowings; - Wait for longest outstanding LGFA bond to mature (currently 2033).	• NZ$1 billion standbay facility from NZ government; • NZ$1.1 million liquid asset portfolio ; • NZ$800 million of Treasury Stocks for repo.	• NZ$25 million paid in capital; • NZ$20 million uncalled capital; • NZ$58.6 million retained earnings; • NZ$1282 million Borrower Notes that can be converted to equity; • Current capital ratio of 2.25% with policy of 2% minimum and target of 3%.

Source: LGFA as at 30 June 2020 and LGFA (2016[37]), Lessons from New Zealand, Presentation to UK Municipal Bond Agency conference.

Only 30 LG councils are shareholders of LGFA (meaning they will receive dividends on their shares). However, borrowing from LGFA is not limited to shareholders. Any LG complying with the LGFA financial covenants can borrow from LGFA, and shareholders do not get better conditions than other LGs. When borrowing from the LGFA, the LG automatically becomes a member of LGFA, and a guarantor if its loans are above NZ$20 million. LGFA can only lend to LGs (not to LG controlled enterprises). LG loans from LGFA are guaranteed by their property tax income: in case of default, LGFA could appoint a receiver to directly collect the tax.

To beat alternative commercial banks costs of borrowing, the LGFA must maintain a credit rating as high as the sovereign. To achieve this, the LGFA imposes a number of financial commitments ("covenants") consistent with A+ rating on LGs which borrow from them (Table 6.3). If a council breaches the covenants, they enter an "event of review", and after 30 days, LGFA can seek repayment of their outstanding loans.

Table 6.3. LGFA Financial Covenants

For councils with external credit ratings	For councils without external credit ratings
• **Net debt / total revenues < 250%**	• Net debt / total revenues < 175%
• Net Interest / total revenue < 20%	• Net Interest / total revenue < 20%
• Net interest / rates (Property tax) < 30%	• Net interest / rates (Property tax) < 25%

Source: LGFA (2018[38]), Investor Update.

Credit ratings are frequent and directly affect reputation of council officials and cost of credit

One particularity of the New Zealand system is its strong reliance on market mechanisms. For instance, a great number of LGs (31 out of the total 78) have a credit rating from a rating agency. These ratings are used as a simple and transparent proxi to evaluate the management of a LG,[36] and all mayors have strong incentives to remain in the very high grades (in June 2020, 3 councils had AA+ ratings, 19 councils had AA ratings, six had AA- and one had A+)[37]. In addition, the cost of loans from LGFA is directly linked to the credit rating of the LG, which gives a second incentive to keep it high (Table 6.4). This credit-rating based incentive is one of the main drivers for LG fiscal discipline in New Zealand.

Table 6.4. LGFA Council Credit Margin (bps)

Council credit rating	Credit margin (bps)
AA	Nil
AA-	5
A+ and below	10
Unrated Guarantor	20
Non Guarantor	30

Source: LGFA (2018[38]), Investor Update.

[36] However, credit ratings only assess the fiscal sustainability of a LG, not it's ability to deliver the services it is responsible for. In this regards, the CouncilMARK program provides a more comprehensive assessment of a LG's management.

[37] Standard & Poor's rating scale is the following: AAA – AA – A – BBB – BB – B – CCC – CC – C – D where AAA to BBB are investment grade, BB to C speculative grade, and D means payment default or bankruptcy petition filed. As a comparison, the New Zealand government is currently rated AA (July 2020).

Standards and Poor's (the leading credit rating agency for LGs in New Zealand) uses a number of key rating factors including liquidity, budgetary management and debt burden to determine the overall credit rating (S&P Glocal Ratings, 2019[39]). The Local Government Funding Agency (LGFA) carries out its own rating of LGs for those which do not have a credit rating using similar criteria (Table 6.5).

Table 6.5. Criteria used by LGFA to rate LGs

Primary criteria	Secondary criteria
• Debt levels relative to population (affordability)	• 30 year infrastructure strategy
• Debt levels relative to asset base	• Quality of assets
• Ability to repay debt	• Capital expenditure plan
• Ability to service debt (interest cover)	• Risk management
• Population trend	• Insurance
	• Governance
	• Financial flexibility
	• Cashflow
	• Budget performance (balanced budget)
	• Affordability of rates (property tax) / deprivation index
	• Natural hazards
	• Group activities (CCO's)

Source: LGFA (2018[38]), Investor Update.

NZ is currently discussing the creation of a new financial instrument to overcome limits from debt ceiling

The 250% net debt to total revenue ratio is quite high and for most LGs, it does not constrain public investment. However, this ceiling does sometimes defer needed public investment, in particular in LG with special characteristics such as: fast growing LGs (such as Auckland); touristic LGs that see a large temporary influx of population which does not pay property tax but who need investment in services and utilities; or LGs coping with the effect of climate change. One key barrier to the supply of developable urban land for example, is the councils' ability to borrow to build the necessary supporting infrastructure (mainly roading, drinking water, wastewater and stormwater infrastructure) (Treasury, 2019[40]). This is often cited as one of the causes for the exceptionally high housing prices in New Zealand.[38]

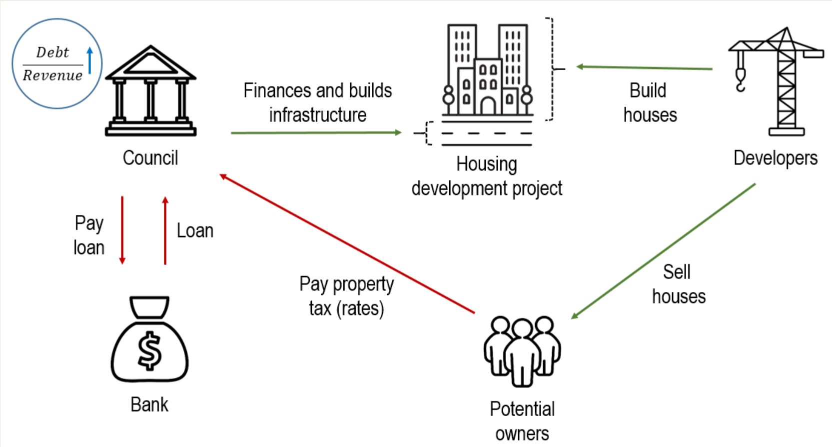
Today, New Zealand has three models for financing and funding public infrastructure: CG transfers (mainly used for roads), LG property taxes, and development contributions (Box 6.4).

[38] The Treasury, Urban Growth Agenda: Infrastructure Levy Model – Development Contributions Information Release, December 2019. Indeed, the future property tax revenues which will be generated by the new developments are not taken into account in the calculation of the debt ceiling ratio.

Box 6.4. Financing public infrastructure: property taxes and development contributions models

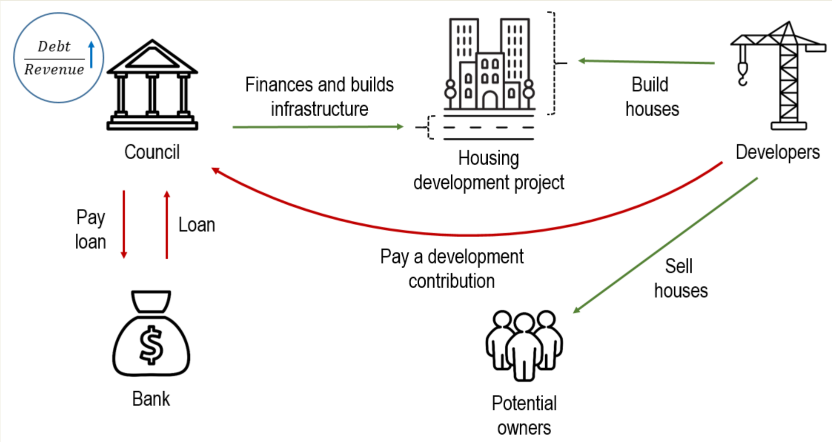
LG's property taxes financing model:

The council borrows money to finance the supporting infrastructure for developing new land and is responsible for the construction of the assets (i.e. debt to revenue ratio of council increases). Developers build houses on this land which they sell to home owners. Once houses are sold and new home owners arrive, property tax income of the council will increase and be used to repay the initial loans.



Development contributions model:

In this model, the council borrows to finance the supporting infrastructure, and is responsible for construction of the infrastructure assets. Developers building the houses on the new land pay a contribution to the council, which is used by the council to repay the loans. The advantage compared to the previous model is that the council receives the revenues for its investments faster, reducing the time mismatch between disbursement of funds and collection of revenues. However, it still increases LG's debt to revenue ratio and is therefore subject to the celling.

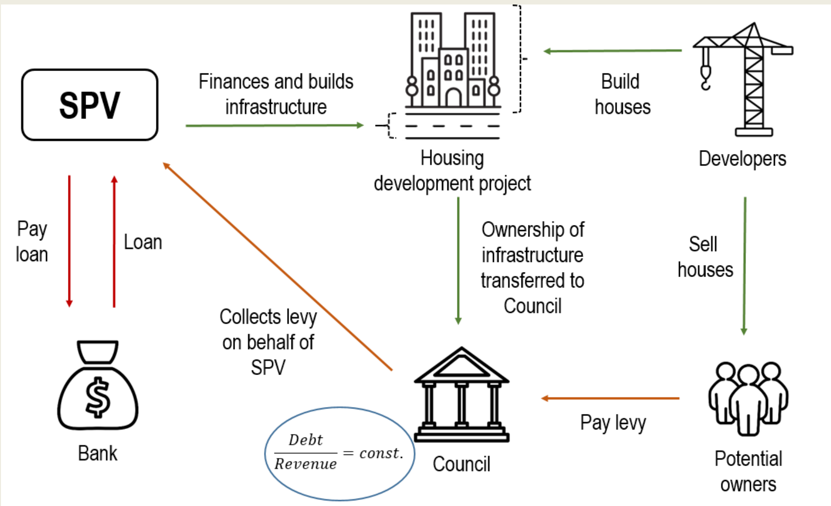


Source: Treasury (2019[40]), Urban Growth Agenda: Infrastructure Levy Model – Development Contributions Information Release.

New Zealand is currently discussing an "Infrastructure Funding and Financing Bill", which would set up a fourth model to finance public infrastructure (Box 6.5). The contemplated Levy model proposes to create a special purpose vehicle (SPV) which would borrow on the market to build the infrastructure asset and would be responsible for the construction of the asset. The SPV debts would be backed by a newly authorised "Levy" (similar to a property tax but earmarked for financing the infrastructure investment) on the owners of the properties which benefit from the infrastructure. The LG would collect the Levy on behalf of the SPV, but if levy payers defaulted, the SPV could seize their property to repay their debts. The SPV would thus be guaranteed by the owners of the properties benefitting from the infrastructure investment, and ultimately, by the properties themselves (i.e. not guaranteed either by the LG or by the CG). In this way, the borrowing for the infrastructure would not be in the LG's books, and would therefore not be subject to or deteriorate the LG's debt ceiling.[39]

Box 6.5. New financing public infrastructure model: the "Levy Model"

The core of the proposed Levy Model involves the setting of a multi-year infrastructure "Levy", which is paid by the beneficiaries (or Levy payers) of the infrastructure projects. The Levy will be enabled by legislation and can only be struck following an Order in the Councils, which will set out the terms of the Levy. A Special Purpose Vehicle (SPV) will be responsible for financing all or part of the project and will have the power to collect the Levy which is used to support the financing.



The Levy will be used to service financing raised by the SPV to cover the costs of the infrastructure. In most cases, the SPV will be responsible for construction of the infrastructure assets. Once constructed, the infrastructure will then be vested with the relevant council (or public body).

Importantly, the Model separates the financing decision of the infrastructure from the Council's usual financing processes and constraints, including the debt being ring-fenced from a Council's balance sheet, It is about providing the flexibility the local authority infrastructure funding and financing system to be able to respond to infrastructure demands.

While the Model separates the financing decision, it does not absolve Councils of their responsibility to their current and future communities to provide the infrastructure they need. The aim of this Model is to enable new housing supply that otherwise would not proceed.

Source: Treasury (2019[41]).

[39] Unlike the LGs, the SPV will be allowed to borrow against a future stream of revenue. However, the SPVs would not be able to borrow from the LGFA, and the cost of borrowing would therefore be significantly higher than LGs' cost of borrowing.

Summary of New Zealand's framework in the light of the analytical framework

New Zealand is a clear example of a market-based system for ensuring LG fiscal efficiency and sustainability (Table 6.6).

Table 6.6. The institutional framework of New Zealand's LG sector & availability of funding options

Funding	Revenue and expenditure autonomy	High	• CG transfers represent 32% of total LG income. • Tax raising capacity is high representing 52% of LG income. Property tax represents about half of LGs' revenues and can be set freely (subject to citizen consultation). • LGs have "power of general competency" on expenditures, meaning they are free to choose the activities they understand to fulfil their statutory role, subject to public consultation.
	Public investment grants	Moderate	• CG provides only a matching grant for transportation (roads).
Fiscal discipline mechanisms	Fiscal rules	Low	• Only balanced budget rule on operating expenditures (golden rule) calculated in accruals. No restriction for capital expenditure.
	Direct controls	Low	• Reporting mechanisms are very developed, but there are no direct controls.
	Monitoring and enforcement mechanisms	High	• Monitoring mechanisms and peer pressure are very strong. Many LGs have credit ratings, the LGNZ association also rates the councils, LGFA monitors their debt levels. • All accounts are audited by the Office of the Auditor General. • In case of severe mismanagement, CG can temporarily replace the LG administration with CG officials.
	Insolvency frameworks	High	• In case of a LG default, lenders can appoint a receiver who can collect the property tax directly for the lender.
Financial instruments	Loans	Moderate	• Loans represent only about 40% of total LG debt. • Most LG borrowing is done through LGFA. Municipalities do not rely on commercial debt. • Only Auckland is too large to fully rely on the LGFA and regularly borrows from commercial banks.
	Bonds	High	• Auckland issues bonds internationally. • The New Zealand LGFA issues bonds on domestic and international markets.
	PPPs and other alternative financing	Moderate	• Possibly high in the future. • A bill is currently under discussion to create a "Levy Model" to finance infrastructure.
	Guarantees	High	• LG debts are guaranteed by their property tax revenues. Lenders can appoint a receiver to collect the tax. • LGFA debt and bonds is guaranteed by all its shareholders (30 LGs) and all LGs borrowing above NZ$20 million. There are currently 45 guarantors.
Financial institutions	CG lending	Low	• CG does not lend to municipalities.
	Public investment funds	Low	• PI funds are small, but an important share of public investment in regions is carried out by the CG directly (ex. National roads).
	LGFAs	High	• A publicly owned financial institution, the Local Government Funding Agency (LGFA) provides 90% of LG loans at rates below commercial banks'. The CG holds 20% of LGFA's shares. The remaining 80% are held by LGs.
PFM syste	Budgeting and reporting practices	High	• LGs use accrual budgeting since 1990. • LGs usually rely on large international firms to prepare their accounts and financial strategies.
	Strategic planning practices	High	• LGs must provide a 30 year infrastructure strategy, a ten year plan and financial strategy, an asset management plan and annual plans and reports. Assumptions of these plans are audited by the Office of the Auditor General.
	Administrative capacity	High	• Administrative capacity is high. Mayors appoint professional Chief Executives. Most LGs outsource their treasury management to private companies (PWC in particular).
Multi-level governance	Vertical coordination and support mechanisms	Moderate	• The Department of Internal Affairs is responsible for the day to day relation with LGs, and the Treasury for issues which could affect national sustainability. • The LG association, LGNZ represents LGs when discussing national policies. It also assesses quality of LG management and provides recommendations and benchmarks.
	Inter-municipal (horizontal) coordination and cooperation	Low	• There are few cases of horizontal cooperation. Some LGs sometimes buy services from larger neighbouring ones.

Good practices from New Zealand

- Strong LG revenue raising autonomy
- Strong LG planning and financial management (accrual)
- Widespread use of credit ratings by LGs
- Strong evaluation culture and use of transparent and simple indicators to evaluate performance of LGs' management (such as CouncilMARK programme)
- Strong monitoring of LGs. Very clear indicators for assessing LG financial health and quality of management
- Municipal financial institution, created with funds from both CG and LGs, but where CG does not guarantee the institution's borrowing/bonds.
- Strong insolvency framework: in case of LG default, lenders can appoint a receiver to collect tax directly
- Development contributions
- Levy model/SPV

Interviewed institutions

The mission to New Zealand took place virtually between the 18 June and the 9 July 2020.

Institutions interviewed
Auckland Council
Department of Internal Affairs, Te Tari Taiwhenua
Infrastructure New Zealand
New Zealand Local Government Funding Agency (LFGA)
New Zealand Productivity Commission
The Treasury, Te Tai Ōhanga
Standards & Poor's

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Annex A. Synthesis of the case studies

Table A A.1 presents the main elements identified in the analytical framework, together with the summary of the relative importance[40] that each of these elements plays in the benchmark countries' frameworks.

Table A A.1. Summary of LG investment funding and financing frameworks

		Denmark	Finland	Ireland	Netherlands	New Zealand
Funding	Revenue and expenditure autonomy	High	Extremely High	Low	Moderate	High
	Public investment grants	Low	Low	High	High	Moderate
Fiscal discipline mechanisms	Fiscal rules	High	Moderate	Low	High	Low
	Direct controls	Extremely high	Low	Extremely high	Low	Low
	Monitoring and enforcement mechanisms	Extremely high	Extremely high	Moderate	High	High
	Insolvency frameworks	Low	Low	Low	Low	High
Financial instruments	Loans	High	High	Moderate	High	Moderate
	Bonds	Moderate	High	Moderate		High
	PPPs and other alternative financing	Low	Moderate	Low	Low	Moderate
	Guarantees	High	High	High		High
Financial institutions	CG lending	Low	Low	High		Low
	Public investment funds	Low	Low	High	Low	Low
	LGFAs	High	High	Low	Moderate	High
PFM systems	Budgeting and reporting practices	Moderate	High	High	High	High
	Strategic planning practices	Low	High	High	High	High
	Administrative capacity	High	High	High	Moderate	High
Multi-level governance	Vertical coordination and support mechanisms	High	High	High	High	Moderate
	Inter-municipal (horizontal) coordination and cooperation	High	High	Low	High	Low

[40] Please note the framework refers to the importance of each of the elements in the national system, not its quality nor stringency (the OECD did not carry out an assessment of the quality of the different elements in each country).