THE RISKS ARISING FROM LOCAL AUTHORITIES' FINANCIAL OBLIGATIONS

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INTRODUCTION

This report continues the inquiry carried out at the request of the Council of Europe on *Recovery of local and regional authorities in financial difficulties*. Its specific aim is to study risks which, should they arise, may lead to difficulties of this kind.

However, the risks are infinitely diverse, both in nature and in terms of their implications, and taking account of risks is a fundamental management concept, in local or regional government as well as in business. The risks which are to be considered therefore need to be defined.

For the purposes of this study, the concept of financial risk may be defined as follows. For a local authority, financial risk means incurring, beyond the usual range of eventualities with which management has to deal, expenses which far exceed its contractual obligations and its budget forecasts, due to circumstances beyond its control[1].

One ambiguity in this regard must be dispelled. Is the study to cover financial risks arising from decisions which local authorities have to take in the course of their duties, or only those arising from financial obligations? The former concept is probably too broad, as it covers virtually the full range of financial matters dealt with under local authority management as a whole. For example, while the risk of overshooting the budgeted cost of building an important public structure financed from the local authority's budget resources certainly constitutes a financial risk, it is not strictly speaking a risk arising from a financial obligation. The same applies to maintenance costs, given that many investment decisions require a satisfactory balance to be struck between the initial cost of the investment and the expenses incurred in maintaining and running the structure or facility. Nonetheless, it would be too restrictive to reduce risks arising from financial obligations merely to paying off debt, although that issue is certainly included.

Moreover, other types of risk which may have considerable financial implications for local authorities need to be reviewed. These include natural disasters (storms, floods, etc) and accidents (fire, emission of toxic substances from industrial plant, etc) in which insurance and national solidarity usually play a role. However, it also covers the economic failure of activities based on a partnership with the private sector, which, in principle, was to incur the financial risk, although the outcome for the local authority may be such that it also has to incur a portion of that risk. Natural or accidental risks are not financial in nature, although their repercussions are; they are outside the scope of this study. By contrast, economic risk arising from an activity undertaken by the local authority, when it thought that it had transferred that risk to the private sector or that it had strictly limited its involvement, is a financial risk arising from a local authority obligation; it may even arise from a strategy to avert financial risk.

[1] This definition is narrower than that adopted by Stéphanie Serve, whereby financial risk "takes the form of an uncertain event affecting the local authority's financial situation in that it leads to a discrepancy between the estimated figures and the final figures for resources and jobs" and "is assessed in the light of the anticipated developments in the local authority's income and expenditure" (*L'évaluation des risques financiers des collectivités locales: une comparaison européenne*, doctoral thesis in business management, Université Paris 12, Institut de Recherche en Gestion, 20 December 2000, unpublished, page 12). We consider that certain uncertainties are a normal management hazard and do not really constitute a risk. Moreover, Stéphanie Serve does not take account of circumstances, although she does incorporate these elements in her analysis.

Given the proposed limitations of the subject matter, in this report risks arising from local authorities' financial obligations will be taken to be those risks which arise from the discharge or non-discharge of contractual obligations by the local authority or its partners and which give rise to additional debt or the loss of receivable claims, which then has to be met out of the local authority's budget. This definition enables the following aspects to be taken into account:

- debt and debt management;
- risks arising from loans granted to third parties (other local authorities, dependent bodies or private companies);
- guaranteeing third-party debt (for example, of firms whose development is backed by the local authority);
- participation in the equity and management of firms, associations or other establishments providing a service to the community;
- implications of the failure of the private company responsible for building or operating a structure and/or a service controlled by the local authority or which is part of its real estate holdings.

The risks inherent in the forecasts which have to be made for each investment decision or for operating a structure or a service are, as such, not all covered by this study. The study covers borrowing needed to finance investments, operational risks arising from investments intended to yield a return (for example, development of land with a view to reselling or renting it and transport infrastructure) and risks arising from public-private partnerships. By contrast, risks that are inherent in any decision, such as the financial implications of geological hazards affecting a building financed solely out of budget resources, must be omitted.

This delimitation may seem arbitrary in terms of investment in infrastructure, which may or may not be relevant to the study, depending on how it has been made. It does, however, have two advantages:

- it emphasises the fact that the study deals with risks arising from direct or indirect financial obligations rather than from the underlying decisions, transactions or circumstances;

- it enables the study to focus on the most recent problems encountered in the management of local finance and of local authority investment. These are issues that are also of particular concern to the European Commission in connection with member and candidate countries, insofar as Community aid may be involved.

The inquiry which was carried out on the basis of the questionnaire drawn up in line with that approach enabled data to be collected on the following countries: Belgium (or more precisely, the Walloon Region and the Brussels-Capital Region), Croatia, Cyprus, Denmark, Finland, Ireland, Norway, the Netherlands, Poland, Portugal, the Czech Republic, Russia and the United Kingdom. The responses to an earlier, more general questionnaire (1999) were also available (*The risks arising from local authorities' financial obligations and the recovery of local and regional authorities in financial difficulties*), as were responses to the separate questionnaire on *Recovery of local and regional authorities in financial difficulties*.

These documents, which vary considerably in their degree of accuracy, were supplemented by information derived from accessible publications; however, there is relatively little scientific literature on this subject and its quality varies. Unfortunately, this is particularly true for local authorities. These sources nonetheless allowed reference to be made to other countries on certain issues. Finally, within the framework of this review, it was not possible to obtain the opinion of financial institutions.

The report is based on the hypothesis that the problem of risks arising from local authorities' financial obligations is primarily that of how to manage those risks. That requires two categories of instrument:

1) regulations prohibiting the incurrence of certain types of risk or subjecting them to precise terms and conditions, which implies *ex ante* identification of the types of risk to which local authorities are particularly vulnerable because of their spheres of responsibility and their activities;

2) instruments or procedures relating to risk prevention which focus on risk evaluation by internal or external supervisory bodies and allow, where applicable, preventative measures to be set in train, together with measures aimed at spreading the risks. The material collected will be analysed from two perspectives.

PART I - RISK IDENTIFICATION AND REGULATION

As a general rule, regulation focuses on the following risks: debt, cash management, the practice of setting up guarantees or guarantee deposits, securities and the acquisition of holdings associated with local authority activity.

1. Debt

In all the countries, borrowing is recognised as being both an indispensable means of financing local authority investment and a risk, insofar as paying off the debt puts pressure on future budgets. Allowing non-specialist agencies to lend to local authorities, although bodies which specialise in lending to local authorities still dominate this market *de jure* or *de facto*, intensifies this risk; it also transfers risk evaluation to these establishments. The risk arising from the debt falls, on the one hand, on the local authority which has contracted the debt, possibly jeopardising its solvency or essential functions, and on the public finances of the state as a whole, insofar as local authority debt is a part of government debt. Borrowing is therefore always regulated, as is debt management, but the degree of freedom enjoyed by the local authorities and the fields to which this freedom applies vary greatly from one country to another. Regulation generally relates to borrowing and less frequently to agencies lending to local authorities and to debt management.

Most countries accept that local authorities may resort to borrowing as a means of financing investment, but rule it out as a means of financing current expenditure, with the exception of liquidity credit, which must be repaid within the year. This solution is perfectly valid, as it leads to investment financing being spread while taking account of its maturity.

Some countries, however, adopt more restrictive measures, even for investment financing. The United Kingdom, Denmark and Germany regulate the total volume of borrowing which may be contracted by each local authority. In the United Kingdom, each local authority may borrow up to a ceiling set for it by the government (*credit approval*). In Denmark, a separate overall financing rate for each region is determined each year with regard to real estate investment borrowing excluding VAT, and for each municipality a financing rate with regard to borrowing to finance investment in public services financed by fees paid by the users; these rates may be exceeded subject to authorisation by the Minister of the Interior and within the limits set for him. In Germany, the regional laws of the *Länder* stipulate that the overall volume of the loans included in the budget must be approved by the *Land* supervisory authorities, which assesses the municipality's financial capacity to handle them.[1] This solution favours overall regulation of public debt. In Poland, the Act on Public Finances of 1998 introduces an *a posteriori* ruling: if the volume of public debt plus the payments budgeted to cover guarantees or guarantee deposits exceeds the limits determined by the Act (50, 55 and 60%), depending on the case and like the state itself, local authorities must freeze or reduce the level of their debt compared with their overall resources excluding borrowing. In Croatia the annual Budget Implementation Act

[1] There are variations from one *Land* to another.

sets the borrowing ceiling for local authorities at 20% of the amount of their own resources for the previous year, and the local authority executive cannot sign a contract until the government has approved the loan in response to a proposal from the Minister of Finance. In Portugal, the largest loans are subject to advance approval being given by the Court of Auditors. In Norway, borrowing by local authorities that are already heavily in debt is subject to ministerial approval; this applies to one-fifth of the local authorities. In Ireland, borrowing must be approved by the minister, who checks whether the loan is commensurate with the expenditure item and whether the local authority will be able to repay it without worsening its financial capacity.

Conversely, some countries allow local authorities considerable leeway with regard to the purpose for which they are taking out the loan; raising finance by borrowing operating costs is therefore not formally ruled out. In most cases, however, control is exerted indirectly. This is true when the law makes it mandatory to pass or implement a balanced operational budget (France, Netherlands and Sweden), which is the equivalent of prohibiting borrowing to finance that kind of expenditure. In France, where the local authorities are considered to enjoy one of the most liberal regimes as far as loans and guarantees are concerned,[1] they may only take out loans to finance their investment expenditure. In Russia, the regulation is limited to ratios: the tolerated deficit may not exceed 3% of the local authority's total resources, or 15% of the total amount of loans contracted during the financial year. By contrast, in Belgium (with the exception of the Walloon Region), Finland, the Czech Republic and Poland, there are no regulations governing the type of expenditure financed by borrowing.

Having said that, it does not seem possible, given the state of available data, to determine any kind of correlation between these different types and degrees of regulation and the extent to which borrowing is used as a means of financing local authority activities and, in particular, their investment activities. The proportion of borrowing in investment financing thus represents, on average, 35% of the local authorities' capital expenditure in the United Kingdom, and 25% of that of the regional authorities in Denmark (ceiling in 2000), 61% of that of the local authorities in Norway, but only 15% of the net investment expenditure of the local authorities in Finland, where, however, borrowing is completely unregulated, and 40% in France, where borrowing to finance investment expenditure is unrestricted.

By contrast, the law makes little use of the definition of prudential ratios to reduce the risks which local authorities may incur by taking out a loan. The ratios are indeed used as instruments with which to analyse local authorities' financial positions (for example, in France, the Directorate General for Local and Regional Authorities at the Ministry of the Interior publishes collections of ratios with averages, and the law obliges local authorities to publish some of them; the same applies in Sweden) without necessitating the setting of legal ratios. Of course, there are exceptions, of varying significance, particularly in central and eastern Europe. In Poland, the cost of the debt may not exceed 15% of the ordinary annual resources; the same threshold is used in the Czech Republic but it is not enforced by law; in Croatia, this threshold represents 20%, calculated on the basis of the previous year; in Russia it may not exceed more than 15% of the expenditure for the financial year, which is more restrictive. By contrast, on Cyprus, the debt ceiling is set at 250% of the total resources, which may be considered high.

[1] Samuel S. Theodore, "Notation des collectivités locales, le diagnostic de Moody's", p. 143 in: Alain Guengant (ed.), *Analyse financière des collectivités locales*, Paris, PUF, 1995.

Since 1995, legislation in the Netherlands has made it mandatory for the local authorities to append to their draft budget a risk analysis which includes non-quantifiable internal or external risks; only quantifiable risks give rise to reserves. That measure is the outcome of the weaknesses revealed by implementing commercial accounting procedures in the local authorities from 1985 onwards, insofar as the evaluation of assets and their depreciation do not follow clear, indisputable rules; nor are the guarantees given included the balance sheet. Although the Dutch authorities recognise that the local authorities find it difficult to make adequate use of it, the risk analysis appended to the budget constitutes an instrument which, in principle, is worth citing as an example, because it encourages local councillors to discuss the risks inherent in the commitments to which they have already agreed or that the local authority is about to undertake.

With regard to the agencies lending to local authorities, the tendency is clearly in favour of deregulation. Within the context of the European Community, this is the natural outcome of the free circulation of capital and the competition rules. In most of the member states there has been a shift has away from a monopoly situation benefiting public service agencies specialising in lending to local authorities to a competitive situation, one in which lending ceases to be the preserve of specialist bodies. However, in many countries specialist agencies are still clearly predominant. The most typical development has to be that of France and Belgium: the Crédit communal de Belgique, set up by the local authorities which were its shareholders, and the Crédit local de France, a subsidiary of the Caisse des Dépôts et Consignations, were privatised and then merged in 1996 to form a single banking group, Dexia, which now operates on a competitive market, on which, however, it retains a dominant position (in France, 42% of lending to local authorities). However, in the United Kingdom, the Public Works Loan Board still provides the local authorities with 71.6% of their total loans and it remains the last resort lender; the same applies to KommuneKredit in Denmark and the Caixa Geral de Depositos (Deposit Bank) in Portugal, in particular. In Germany, 97% of local authority borrowing is arranged with the savings banks, which are owned by the local authority, and the central banks of the *Länder* (*Landesbanken*). In central and eastern Europe this kind of institution is rare, which generally makes it difficult for local authorities to gain access to loans, apart from in the main cities; in this field, however, the role played by the National Environmental Fund in Poland, the First Municipal Bank in Slovakia should be noted. Plans to make lending agencies competitive appear to exist only in Portugal.

Local authorities increasingly have access to the international market, although this does not appear to represent a significant proportion of their borrowing, except in particular cases. However, the local authorities in Ireland are only allowed to borrow on the national market.

The development of market conditions and public finances emphasises the importance of debt management. Generally speaking, the same regime applies to renegotiation as to borrowing: it is not regulated when borrowing is not regulated, and subject to control when the borrowing regime is. However, even if renegotiation is not regulated, local authorities may not take part in speculative activities.

The opening up of lending to local authorities to non-specialised agencies and progress in banking techniques have considerably increased the range of products on offer to local authorities – and new risks have also been added. Local authorities may now borrow at an adjustable or floating rate rather than at a fixed rate only; loan agreements may provide for guarantees of a maximum or a minimum rate; they may enter into interest rate swap agreements; and they may borrow in foreign currency, as we have seen. Moreover, rather than borrowing to finance a project, each year local authorities may enter into a contract to finance annual investment. In that context, the more freedom local authorities are given under national legislation, the more likely they are to take major risks in managing debt.[1] The case involving interest rate swap agreements in the United Kingdom in the 1980s illustrates that point.[2] Under an agreement of this kind, the local authority lends, for example, a sum of money to a bank at a fixed rate of interest. In exchange, the bank lends it the same sum of money at a floating rate; interest rates are thus exchanged, the two transactions cancelling each other out with regard to the principal; of course, the transaction may be concluded the other way round. For the two parties it represents taking a gamble on interest rate movements. This technique enabled many local authorities to make large gains at a time when they were faced with a tightening of their resources as a result of the measures introduced by the Thatcher governments. At one time a London borough *(Hammersmith and Fulham London Borough Council*) held half of the world market for interest rate swaps. However, as interest rates began to rise again sharply from autumn 1988, that local authority soon found itself in serious financial difficulties. The District Auditor, whose task it was to monitor local finances, then started legal proceedings with a view to having these contracts declared illegal and null and void. The House of Lords decided, on the one hand, that the interest rate swap agreement went beyond the limits of the powers conferred on local authorities by law and, on the other, that the latter were not entitled to enter into a purely financial transaction the sole aim of which is to make money; it thus declared the interest rate swap agreements null and void together with transactions initiated after the start of legal proceedings by the District Auditor, on the grounds that the local authority was unable to compromise an agreement that it had no authority to enter into. Depending on the contracts concerned, this ruling meant that the losses had to be borne by either the banks or the local authorities (*Westminster City Council, Glasgow City Council*), but to re-establish confidence in the local authorities on the financial market meant that they had to make a sacrifice, as did the government. In France, a circular issued in 1992 alerted the local authorities to the risks inherent in this kind of contract and its probable illegality owing to its purely financial aim. This example highlights the risks which may arise from the inappropriate transposition of private-sector financial manoeuvres to the financial management of local authorities, as these risks, when they arise, are always borne by the taxpayer. Moreover, even if there is no speculation involved, highly specialised staff, which only the largest local authorities can hope to recruit, are needed to apply these techniques.

The lending agencies have developed alternatives to the classic loan which have gained a certain amount of ground in private business and which have also been introduced into local authority financing of public facilities, at least as far as the law permits. The two most widespread of these alternatives are leasing and factoring. Leasing takes the form of a contract between one person financing something for use by another, with the user paying the former a rent which covers the financing of the object and being able to take advantage of the option to buy the object when the contract expires by paying the balance of its agreed value. Factoring is a contract according to which a financial agency purchases the calculated receipts of a third

[1] For a general presentation of these techniques, see: Joël Bourdin (2001), *Les finances communales*, Paris, Economica, pp. 255 f.

[2] Martin Loughlin (1990), “Innovative financing in local government: the limits of legal instrumentalism”, *Public Law*, autumn, p. 372-408 (see the second part in the winter 1991 edition); John Bell (1992), “The financial difficulties of local authorities in Great Britain: the Hazell vs Hammersmith & Fulham LBC judgement”, *RFDA*.1992.80 ; see the judgement: [1991] AC, 2 WLR 372.

party, thus allowing the latter to obtain resources which will permit him to finance the investment needed to produce the returns which he has transferred and which he will have to pay over at the agreed maturity date. Common to these contracts is the fact that they transform a capital expenditure item into operational expenditure, thus falsifying the local authority's balance sheet. Although there is insufficient information on this subject, local authorities seem to be able to make use of this system in those countries in which their expenditure is the least subject to regulation; by contrast, in other countries these banking techniques are subject to restrictive regulation as far as local authorities are concerned. In France, local authorities may enter into leasing contracts to finance structures or facilities within the field of energy saving (Act of 15 July 1980) and activities subject to VAT (1987 Finance Act); however, a leasing agreement may only be used as a last resort, it may not be for longer than ten years and the supplier must be chosen by means of a tender procedure.[1] In Germany, using these financial techniques is also regulated by the *Land* government as, pursuant to *Land* legislation, the approved borrowing ceiling applies to all payments made by the local authority which may be considered repayment of the loan.[2] The effect of these ways of financing expenditure, which are actually investment expenditure, is to disguise the local authority's real financial position since part of its debt appears as operational expenditure (rent) or as an advance on ordinary receipts (factoring), and to expose the local authority to higher financial costs than those of a classic loan, at least in most cases.[3]

2. Cash management

The cash account can be defined as those funds which are available for use and which permit the local authority to meet its expenses at any time.[4] From the point of view of risks, the cash account may be viewed from the perspective of depositing funds, investing them and flows.

Nowadays, in most European countries local authorities seem to be free to deposit and manage their cash account as they see fit; however, they may be subject to constraints with regard to investment that are intended to prevent their being exposed to risks which could jeopardise the local authority's solvency.

Of the countries under review, those which accord the greatest amount of freedom to the local authorities are Ireland, the United Kingdom, Finland, Norway, Netherlands, Croatia, Poland and the Czech Republic. In those countries, the local authorities are free to chose the bank at which they will place their funds on account, nothing prevents them from holding different accounts, at least when their object is well established, and they are free to invest their available funds. However, they are legally obliged to manage their resources prudently. In the Czech Republic, subsidies may be dependent on their being deposited in a special account. Strangely enough, other than in Poland, the choice of the bank which will receive the local authority's deposits does not seem to be subject to a compulsory tender procedure.

[1] G. Marcou, "L'expérience française de financement privé…", op. cit. p. 92-93.

[2] Manfed-Jürgen Matschke / Thomas Hering, *Kommunale Finanzierung*, Munich / Vienna, Oldenburg, 1998, in particular pp. 155-173.

[3] Ibid., in particular pp. 169 and 173.

[4] Joël Bourdin, op. cit. p. 326 f.

In other countries, the local authorities are free to decide where to deposit their working capital but their investments are regulated. In Denmark, for instance, these investments are thus limited to bonds and investment certificates. In Portugal, investments are limited to public sector paper (shares or bonds). On Cyprus, a local authority may only invest its available funds in government paper.

Finally, in a third group of countries, both investment and the depositing of available funds are regulated. In Belgium, the recipient must place available funds on current accounts at the Office des chèques postaux or public lending agencies, with the exception of those funds which are raised by borrowing and which may remain on deposit with the lending establishment. Investment may only be in securities issued by public or private institutions governed by Belgian law; in practice, Dexia manages most of these investments.

In that respect, the French system is the most highly regulated. The local authorities are obliged to deposit all their liquid assets with the Treasury, with the following implications: each local authority has a single account and may not maintain a deposit account in a third-party agency; in accordance with the principle of a single cash account, all movements of funds are grounded; the local authorities may not have a negative cash account, the public accountant being obliged to refuse any payment for which insufficient funds are available; only the public accountant, the direct accountant of the Treasury, is authorised to handle the funds. Finally, Treasury deposits are free of charge. In principle, these rules prohibit local authorities from granting loans or advances or from making investments, unless they are given a dispensation, other than in funds derived from extraordinary resources (transfers of title, donations, etc); these investments may only be made in Treasury bills or government or government-backed loans. In return, however, the Treasury collects local taxes and pays the elected amount over to each local authority; the state thus incurs non-collection risks. Moreover, direct taxes are paid in twelfths, irrespective of the intervals at which they are collected (in fact, they are collected annually, unless the taxpayer has chosen to pay monthly); indirect taxes are paid quarterly. The main state assistance to the local authorities, the overall operating grant, is also paid on a monthly basis, subject to end-of-year adjustment. Once criticised as being contrary to the principle of the free circulation of capital, this system is rarely criticised today; in particular, it is reinforced by the new articles 101 and 102 of the Treaty establishing the European Community and the Council Regulation of 13 December 1993, which omits the obligation to deposit public authorities' capital with the Treasury from the prohibitions set forth therein.[1] Moreover, local authorities may obtain free advances from the Treasury as an exception and up to a ceiling, above which a very low rate of interest is charged (3.5% for a maximum of two years, also up to a ceiling). This system actually has very great advantages: for the local authorities it securitises their tax revenue and their liquidity, and for the state, as it increases the volume of movement of funds to which cash management applies, thus reducing the need to take out short-term loans. Italy has a very similar system, especially since the Act of 29 October 1984 establishing the system of a single cash account for public entities and bodies.

However, since it is in the local authorities' interests to reduce their working capital if their deposits are not remunerated, management techniques have been developed that are geared to the symbolic objective of the "zero cash account", based on the calculation according to which short-term loans to cover short-term cash shortfalls may be less onerous than the "non-yield" of non-remunerated available funds.

[1] Joël Molinier, "Les contraintes et potentialités financières au regard de l'Union européenne", *Revue française de Finances publiques*, 1995, no. 49.

In countries in which the local authorities are completely at liberty to deposit their funds in private banks, one might ask if a special insurance or reinsurance system would not be useful to counter the risk of bankruptcy. That question is particularly relevant in those countries in which the banking system is new and fragile.

3. Guarantees and guarantee deposits

Guarantees and guarantee deposits are methods of intervention to which the local authorities are all the more tempted to resort as they do not seem to imply any cost in terms of the local authority's budget, while enhancing the beneficiary's credit with the financing agencies. However, if the risks have been poorly assessed or if unforeseen circumstances lead to the beneficiary becoming insolvent, the debt is transferred to the local authority. Hence granting a guarantee or a guarantee deposit is often subject to certain conditions or restrictions. However, very different solutions can be seen in this respect. Some countries have adopted a very liberal regime, according to which the local authorities are free to provide a guarantee or a guarantee deposit for third-party bonds, and the amount of these holdings is not even taken into account when the amount of their debt is calculated. This is true of the United Kingdom, Sweden, Finland and the Czech Republic. In Finland, however, in practice, a guarantee or a guarantee deposit is authorised to foster employment in those local areas with a high rate of unemployment and only a municipal councillor is entitled to refer the matter to the administrative tribunal to have it annulled; in most cases, however, the beneficiaries are economic or social bodies running the local public services, and, in particular, social housing agencies. In Sweden, housing is by far the main beneficiary of this type of aid (in total nearly SEK 18,000 of a sum of SEK 21,773 per inhabitant on average).

In many countries, using this type of intervention is explicitly limited to the field of public services or services to the community. In Ireland, the local authorities may only provide a guarantee for those bodies whose activity is likely to benefit the local community. In Belgium, local authorities may guarantee the loans of bodies which are social in nature (non-profit-making organisations, public welfare centres, public hospitals, etc). In Norway and in Denmark, local authorities are free to guarantee third-party commitments, with the exception of commercial enterprises; in fact, they therefore give their backing to local public enterprises and social welfare agencies. In France, the law underpins the level of commitments of this nature by ratios set by regulation, but does not apply them to guarantees or guarantee deposits granted to social housing agencies or agencies which receive government-backed loans (*communes*), or to institutions or bodies providing a public service (departments and regions). In Croatia a local authority can only guarantee loans to institutions or firms which it owns or in which it has a majority holding.

Other countries control the level of local authority guarantee commitments or guarantee deposits by classifying them as part of the latter's debt, with the result that they correspondingly reduce their borrowing capacity. This is the case in Croatia, in Denmark, in France, where the law provides that the sum of guaranteed annuities and the annuities of the local authority's own borrowing may not exceed a percentage determined by decree of the total of the receipts of the operational division (*Code général des collectivités territoriales*: in particular, art. L. 2252-1, 3231-4 and 4253-1), and in Russia (a percentage – 5% – of local authority expenditure). In Poland, guarantees or guarantee deposits are taken into account in triggering the warning thresholds with regard to debt as defined by the 1998 Act on Public Finances.

By contrast, few countries seem to place a total ban on local authorities making use of this type of intervention. This is, however, the case in Portugal and Cyprus.

If the volume of undertakings to provide a guarantee or a guarantee deposit is to be controlled, there needs to be transparency with regard to the commitments. In those countries which have aligned local authority accounting procedures with commercial accounting, these commitments are not included under local authority borrowing and are not recorded with it in the balance sheet liabilities; by contrast, they classed as extra-budgetary, off-balance-sheet commitments and are the subject of an explanatory note or of an analysis in the annual report (Belgium, Sweden, Finland and Ireland).

From the above, it can be deduced that the most vulnerable local authorities are those which are free to guarantee third-party undertakings, but which are not bound by any precise obligation to make their activities public or to ensure transparency with regard to the public.

4. Collateral

Collateral is a way of ensuring the creditor that he will be repaid the loan on the goods belonging to the debtor if the latter should default. Collateral makes for ease of access to credit but puts the debtor's assets at risk. If the debtor is a public authority, its assets – or at least the largest – are, in principle, linked to the performance of its legal duties. It follows that they may be compromised in the event of the public authority defaulting if collateral has been agreed, even if, in practice, taxation and the durability of public authorities make this risk unlikely. With regard to local authorities, two groups of countries can be contrasted according to whether or not they allow collateral to be granted on real estate owned by the local authorities. Contrary to what might be expected, this contrast does not correspond to that of property regimes based on the legal status of the owner, ie whether the owner is, under law, a public body or a private person.

Hence, in the United Kingdom, a common law country (with the exception of Scotland), with a single property regime, even if the trust system can authorise it to be split in two in favour of the trust beneficiary, the local authorities may not use their assets to guarantee a loan and their borrowing is backed only by the flow of the sum of their revenue. Conversely, in Ireland, which is also a common law country, there is nothing to prevent the local authorities from agreeing to use their assets to provide collateral and nothing prevents distraint of that property should they default, although it is highly unlikely that a local authority will find itself in a situation in which it is not able to repay a loan, and, in any case, this never seems to have happened. In Norway, Finland and Denmark, local authorities may agree to use their assets as collateral on their property, unless there is a legal provision prohibiting them from doing so, and likewise there is nothing to stop those assets from being seized if the local authority defaults. However, in Denmark this collateral is not required because the extensive fiscal powers of the local authorities are sufficient to guarantee the loans that they take out, whereas in Finland and in Norway, for the same reason, such collateral, if granted, is considered to be risk free and there is no known case of default by a local authority which would have led to the loss of some of its assets.

In those countries with a Romanist tradition, by contrast, the distinction between the public and the private sectors results in it being prohibited to use public sector assets as collateral to guarantee any debt contracted. The basic principle remains the inalienability of public-sector assets, and that principle, which was once related to Crown privileges, can be justified in modern times by the fact that those assets are allocated to the functions to be carried out by the public body. By contrast, there is nothing to stop private-sector assets from being used. That is the case in Belgium, France, Italy, Spain and Portugal.

However, the rule has been relaxed in recent years, either to facilitate the redevelopment of public-sector dependencies with traditional principles which take no account of the value of their assets or to establish equal treatment, as least formally, of public bodies and private individuals in respect of guarantees relating to their undertakings. Thus, in France, the Act of 5 January 1988 (*Code général des collectivités territoriales*: art. L.1311-2 et seq) allows regional authorities and their public establishments to grant a lease (of between 18 and 99 years) to an individual on a dependency within their public or private domain with a view to achieving the objective of providing a service to the community: the ensuing real-estate title grants ownership of the structures which he builds on that land to the buyer; this real-estate title and the structures can be mortgaged but only for loans aimed at financing the completion or the improvement of the structures, which makes it easy for the buyer to gain access to bank loans. However, the regional authority remains the final guarantor: the amount of these loans is taken into account when calculating the amount of guarantees and guarantee deposits which it is authorised to grant to a private individual and, in the case of the mortgage being used, it has the choice of authorising the transfer of the mortgaged property or of assuming the cost of the debt; this is why the mortgage agreement remains subject to its approval.[1] Use of these options is current but not very widespread.[2] Italian law remains more traditional, but, on the other hand, the provisions of the civil code relating to public property can be interpreted as allowing the alienation of non-disposable assets or real-estate rights to be set up in favour of third parties on such property unless their allocation has been challenged.[3] However, this applies only to rather exceptional cases. In Spain, while the law has relaxed the rules applicable to state-owned property, with regard to the occupation concessions, works concessions and the possibility of the user being paid by the public authority (Act 13/1996 on fiscal, administrative and social measures, amending, in particular, the Act on the roads), the regime of public ownership has not undergone any substantial alleviation, particularly with regard to local authority assets (Act 7/1985 on the bases of the local regime: art. 80; royal decree 1372/1986 on local authority assets), despite much doctrinal criticism.[4] Whatever the case may be, none of the developments that have been achieved or envisaged challenges the principle of the inalienability of public property by virtue of its allocation. Note that this is not a problem under common law, owing

[1] For further details, see in particular: Jean-Bernard Auby, “Un précédent: le droit réel conféré aux occupants du domaine public des collectivités territoriales”, *JCP éd. notariale et immobilière*, 13 Sept. 1996, no. 37 ; Christian Lavialle, “Délégation de service public et domanialité publique”, *Droit administratif*, February 1998, p. 6 ; G. Marcou, “L’expérience française de financement privé des infrastructures et des équipements”, *Annuaire des collectivités locales 1999*, GRALE, Paris, Litec, especially p. 87. Determining real-estate rights on state-owned property, governed by the amendments introduced by the Act of 25 July 1994 to the code on state-owned property, is based on completely different modalities.

[2] Around one hundred cases in 1996.

[3] Rocco Galli, *Corso di diritto amministrativo*, Padua, CEDAM, 2nd ed. 1996, p. 343.

[4] Alberto Ruiz Ojeda, *Dominio público y financiación privada de infraestructuras y equipamientos. Un estudio del caso francès y análisis comparativo de la reciente regulación española*, Madrid, Marcial Pons, 1999; Francisco Javier Jiménez de Cisnero Cid, *Obras públicas e iniciativa privada*, Madrid, ed. Montecorvo, 1998.

to the possibility of granting very long-term leases which are deemed to be ownership rights and which may themselves give rise to collateral being established.

German law has a broader concept of local authority property, similar in form to that of the state (the Federation or the *Land*) via the concept of wealth (Vermögen), which combines fixed and movable assets, which are frequently classified in terms of their substance, and the most important of which are assets allocated to activities which are the remit of the local authority (*Anlagevermögen*). German law makes no distinction between the public and the private sectors, but, on the one hand, it prohibits any use of local authority assets as collateral without authorisation by the supervisory authority of the *Land*, and, on the other, the local authority may acquire only those assets which are necessary for it to carry out its tasks and may only dispose of those that it no longer requires, subject to control by the supervisory authority of the *Land*, which takes the form of a statement or a formal authorisation, as the case may be.[1]

Certain developments of German law and of Belgium law need to be compared since they, by way of a litigation reform and guaranteeing the imposition of financial sanctions on the public authority, allow, in certain circumstances, seizure of assets owned by public bodies. Note that in these two countries, litigation of entitlement is derived, in principle, from the civil code and the ordinary tribunals. However, in Germany distraint is subject to authorisation by the supervisory authority (of the *Land*), which checks that the tasks of the local authority will not be compromised, and in Belgium, pursuant to an Act passed in 1994, it is the task of the public authorities to draw up a list of their distrainable assets; failing this, or if this list is too small, the assets which are obviously not needed for them to carry out their work or to continue to provide a service to the public may be seized. In practice these provisions are rather symbolic in nature and are hardly ever applied.

By contrast, there are very few rules governing the commitment of local authority assets in the countries of central and eastern Europe. In the Czech Republic, the law does not currently restrict the use of local authority assets as collateral and, should the local authority default, seizure of the assets is not subject to any particular condition or procedure. The state may only determine conditions relating to the use of assets transferred free of charge to the local authorities, or restricting the right of the later to use them. Similarly in Poland, there is no legal limit to the use of local authority assets as collateral; it is left entirely to the discretion of the parties concerned; it is perfectly feasible to set up a mortgage to secure a loan granted to a local authority, and common law procedures may be used if the debtor municipality should default. The situation is identical in Croatia: local authorities, which have the status of public corporations, are in the same situation as a private owner, under the Civil Obligations Act (53/91) and the Ownership Act (91/96), when they use their assets as collateral. The same still applies to Russia, by the combined effect of the legal provisions on the bases of local autonomy of 1995, pursuant to which the local authorities are free to use their assets as they choose, and the provisions of the civil code (art. 126) on the basis of which the local authority is responsible for the commitments by which it is bound in terms of its assets. In this area, the break with the administrative pattern of the former socialist states is evident, but so too is the loss of continuity with the legal and administrative systems which preceded its introduction. For the moment no case of this risk having arisen can be cited, but it must be stressed that,

[1] Alfons Gern, *Deutsches Kommunalrecht*, Baden-Baden, Nomos, 2nd ed. 1996, nos. 700 to 705; for further details, see: Weiß, *Erwerb, Veräußerung und Verwaltung von Vermögensgegenständen durch die Gemeinden*, 1991.

generally speaking, the financial situation of the local authorities is far more precarious in these countries than in western Europe, this following on from the general economic situation despite the progress which has been made, and the fact that the level of their own resources, and in particular the level of their own fiscal resources, is very low. As has been shown with regard to the Nordic countries, where the legal situation is not very different, the fiscal capacity guarantees, by contrast, the solvency of the local authorities, whereas on Cyprus, where the fiscal capacity of the local authorities is weak, setting up collateral is subject to approval by the Ministry of the Interior. In the countries of central and eastern Europe, between transfers (whether grants or a share in the proceeds of shared taxation) which barely cover compulsory expenditure and their own resources which only allow very little room for manoeuvre, it is possible that crisis situations may occur, leading to the loss of some assets, unless the state intervenes *de facto* as a guarantor of last resort.

5. Participation

Insofar as the local authorities become involved in business activities, they are led to assume certain risks that are linked to market developments. This is particularly so when they set up firms or acquire stakes in firms, which is why such activities are generally regulated and must be broadly related to the tasks that they have to carry out.

The countries of Europe present very different profiles as far as management of local public services is concerned: not only because the number of these services is dependent on the responsibilities of the local authorities, but also because the weight of the public sector and that of the private sector vary considerably from one country to another, despite the general tendency towards private sector participation in all the countries. In the Scandinavian countries, Germany and even the United Kingdom, the local public sector remains broadly predominant; in the United Kingdom, privatisation has affected particularly those public services whose management was the responsibility of public bodies that are no longer subject to local authority control; the share of the private sector is greater, however, in France or in Belgium. Unfortunately, there are insufficient homogeneous data to enable an informative systematic comparison to be made.[1]

However, if one examines the financial risks which may be incurred by local authorities, they have more to do with the nature of the activities than to the way they are managed. The management of local public services is less risk-prone than interventions aimed at supporting economic development, by developing land, for instance, or a neighbourhood which is intended to attract property developers or industrial companies. All are included, however, in the public-service activities of the local authorities. In that respect, the criterion of aiming to provide a public service is of little significance in terms of exposure to risk; its significance is primarily ethical and political: that objective is what legitimises public intervention even if it fails.

In the United Kingdom local authority initiatives have sometimes clashed with the principle limiting the responsibilities of the local authorities to the powers conferred upon them by law.

[1] However, an overview is given in: D. Lorrain / G. Stoker (ed.), *La privatisation des services urbains en Europe*, Paris, La Découverte, 1995.

However, since the 1991 and 1998 Acts in Ireland, and the 2000 Act in the United Kingdom, the local authorities have been at liberty to take any initiative aimed at promoting the various aspects of the well-being of the community and, as the British law stipulates, "economic, environmental and cultural". It must not be forgotten that, on the basis of various legal provisions and particularly on the basis of the law of 1970, *Local Authorities (Goods and Services) Act*, in the United Kingdom they had been able for a number of years to set up a very large number of companies, which, if necessary, also offered their services to the neighbouring local authorities, allowing them to use their excess capacities. In Ireland, by contrast, the role of the state or public sector bodies has been predominant; while local authorities are free to form companies, the practice is limited. In the United Kingdom, the level of local authority equity holdings is not regulated by law; however, since 1995 (*Local Government and Housing Act* 1989, and *Local Authorities (Companies) Order* 1995 – SI 1995/849 amended) a distinction has been made in the United Kingdom between regulated companies and the rest. Regulated companies are those in which the local authority has a majority equity holding or is able to exert a decisive influence, in which case loans taken out by that company are recorded under local authority borrowing; conversely, in the non-regulated company, the private partners incur all the risks and loans are only debt incurred by the company; this is clearly a major incentive to seek partnerships in which local authorities have only a minority holding. Article 137 of the 1972 Act (and its equivalent in the 1973 Act on Scotland) granted the local authorities very broad discretionary powers with regard to any expenditure which would benefit all or some of their inhabitants, but put a strict upper limit on that freedom (3.50 pounds sterling per inhabitant). This provision no longer applies to the main local authorities, but still applies to parish councils.

In the other countries, the conditions under which local authorities may intervene are more narrowly defined by reference to public interest, defined strictly with regard to the market.[1] In Sweden, where there is a vast local public sector and where many local public services that are business-oriented in nature are managed by companies which are owned by the local authorities, local authority intervention in support of specific companies is prohibited; jurisprudence established since the 19th century on this point has been sanctioned by the provisions of the new 1991 Act on local authorities. The same is true in Finland, where, however, it has not been necessary for the legislator to intervene; intervention has mainly to do with the sphere of the economic activity. However, in Sweden, the local authorities are responsible for managing their officials' pension funds, ie the investments which are to enable pensions to be paid without making cuts in the current budget necessary; each local authority defines the risks that it agrees to take. One might think that this represents major risk-taking at the level of a local authority, which is even more surprising than if management was organised at the level of pension funds of the whole body of officials. In Denmark, the law is more restrictive: local authorities are prohibited from investing private capital in a company, unless this can be justified by acquisition of knowledge; a company may be set up under private law, possibly with other local authorities, only to manage mandatory services. Conversely, in Norway, local authorities have a surprising degree of freedom in this area, only some sectors such as banking and insurance being closed to them; their interests thus extend from housing to shipbuilding yards (the latter being rather exceptional, as one might guess) via quarrying. However, since 1993, they are no longer allowed to guarantee the debts of such companies.

[1] For a comparison of six countries, see G. Marcou, "Local government and economic development", pp. 191-235 in: G. Marcou / I. Verebelyi (ed.) (1993), *New trends in local government in Western and Eastern Europe*, Brussels, Institut International des Sciences Administratives (dist. Bruylant).

In France and in Germany, apart from mandatory public services, it is only permissible for local authorities to set up public services that are industrial, commercial or business-oriented in nature if there is insufficient private initiative. Under French administrative case law, since the start of the 20th century, a local public holding is linked to the fulfilment of a need which is not met by an appropriate offer from the private sector.[1] In Germany, the local authority enterprise must be in keeping with the capacities of the local authority and it must be impossible to meet the objective of public utility better and more economically by a private initiative. This doctrine was introduced by the 1935 local authority act to counter the significant development of local authority business ventures in the Weimar Republic; these initiatives had led many of the local authorities into serious financial difficulties. The terms of the 1935 Act were taken up again after the second world war with some variations in the local legislation of the *Länder*.[2]
In Germany and in France, the terms and conditions governing the establishment of mixed-economy companies differ in detail not in their general orientation. Unlike French law, German legislation does not make it mandatory for local authorities to have a majority holding; however, they do have to maintain control of the company otherwise they would be illegally transferring responsibility for an activity which is rightfully theirs to a private body.[3] Other European countries have taken similar courses, particularly Belgium and Portugal. In Belgium, local authorities may set up business or commercial companies which are ruled by the law on commercial companies, or associations in the course of carrying out their duties; they have been able to extend intervention to the banking sector, as is shown by the example of Crédit communal de Belgique. As in Germany, if the local authorities delegate some of their responsibilities to a body of this kind, they must control it. However, formal control by local authorities is not sufficient to prevent risks, as is shown by numerous examples cited regularly by the courts of auditors; in particular, diversification of the activities of savings banks and the banks of the *Länder* in Germany has brought to the light the risks that that might entail for the public authorities which own them and may have to sustain any losses out of their budget. This full liability has given rise to objections, as it was considered it might hinder fair competition. In accordance with the European Commission's proposals, liability will be strongly reduced in the future.

In the countries of central and eastern Europe, the situation is characterised by the greater or lesser persistence of the former management structures. Poland is probably the country which has moved farthest from this, and the conditions according to which a municipality may carry out an economic activity are scarcely different from those cited for Germany or France; however, according to Polish law, the level of unemployment in the local authority may justify the latter acquiring a holding in a commercial enterprise whose activities are unrelated to services to the community (Act of 8 March 1990 amended, art. 9). Nonetheless, the ultimate aim of such an initiative must remain that of meeting the needs of the community. On the other hand, the freedom of the counties (*powiat*) and the regions (*voïvodes*) to intervene is limited to services to the community, including the establishment of companies; the *voïvode* may also

[1] There is a considerable amount of literature in France on this subject: reference is made only to Jean-Claude Douence et al, *L'action économique locale, décentralisation ou recentralisation*, Paris, Economica, 1988; "L'action économique locale", *AJDA*, 1992, special edition, April, p. 68-76; "Le droit de l'action économique locale à l'épreuve du partenariat", *Revue d'Economie financière*, special edition 1995, "Partenariat public-privé et développement territorial", under the direction of Isabelle Chatrie and Jean-Michel Uhaldeborde.

[2] Some laws, like that of Baden-Württemberg, have not retained the condition relating to private initiative but case law appears to neglect these nuances.

[3] For further details, see: G. Marcou, "Les modes de gestion des services publics locaux en Allemagne, et le problème de l'ouverture à la concurrence", *Revue française de Droit administratif*, 1995, no. 3, pp. 464-496.

intervene in matters relating to promotional, educational and publishing undertakings to foster the development of the *voïvode*. In the Czech Republic, however, local authorities may set up commercial enterprises with no other restriction than the obligation to use the legal form of the public limited company and to participate in setting up the corporate equity. In Russia, the law applies the opposite principle, and local authorities may not, in principle, participate in commercial companies, unless the law rules otherwise; in reality, they continue to manage many firms despite their having been transformed into companies which are ruled by the law on commercial companies. Local councillors often see this as a source of potential revenue, and the profits of some of these companies go a little way towards offsetting the losses attributable to others. In that context, it is not easy to define the limits of local authority intervention, and we have seen what uncertainties they still involve in some western European countries. Nonetheless, the local authorities would reduce their financial risks if they succeeded in making a clearer distinction between public services and activities which have solely to do with economic freedom.

PART II - PREVENTION AND SPREAD OF FINANCIAL RISKS

Given the legal framework within which the local authorities are obliged to deal with certain financial risks arising from their activities, how these risks are handled may be analysed according to two essential aspects: risk prevention and risk spreading. Prevention stems from a corpus of management controls and practices which aim to clarify the public decision and to avoid commitments which would expose the authority to risks that are too great. The aim of risk-spreading is to transfer some of the risk to the local authority's partners or to the users; but it must be stressed from the outset that it just as often implies that the local authorities share the private investment risks that their projects aim to mobilise, with the result that the public-private partnership itself entails risks for the local authorities that are all too often neglected.

1. Risk prevention

The public controls to which the local authorities are subjected may contribute to preventing risk, if they are organised in such a way as to permit assessment of those risks. In some countries, the banks which assess the ability of the local authorities to deal with their debt and the rating agencies, may also play a role in risk prevention; but practices and views in that respect vary considerably from one country to another. Management structures and the perfecting of techniques for analysing the local authorities' financial position may also be an effective prevention method. Finally, the need to keep the local councillors and the citizens informed, which is governed by law, also helps certain risks to be avoided by permitting the implementation of political control.

A. Public controls

We have already encountered controls which apply to different types of activities which may expose local authorities to financial risk. In some cases, the objective of the control is to prevent local authority debt from unduly increasing outstanding public debt (particularly in the United Kingdom and in Germany); in most cases, however, the impact of the control is to prevent the local authority from incurring debt that is beyond its ability to repay or from becoming involved in business ventures that are too risky. However, the aim of that control is not generally clearly defined, and there is nothing to indicate that it is based on an accurate assessment of the economic and financial situation; an expert appraisal of that situation must be available in the services responsible for the control.

This objective appears, however, in the legislation of some countries and institutions able to carry it out can be identified. In Germany, the supervisory authority in the *Land* checks the accounting and the financial capacities of the local authority for the amount of the loan that it envisages taking out, together with the business ventures which it has in mind, whether this relates to setting up companies or acquiring a holding.[1] In France, the prefect monitors the decisions taken by local mixed-economy companies with a view to protecting the finances of the shareholder or guarantor municipalities: the deliberations of the board of directors or the supervisory board of the company and the ownership agreements relating a structure and the development concessions are transmitted to the prefect within two weeks of their being adopted, and he refers the matter to the regional court of auditors if he thinks that a deliberation is such that it will seriously increase the financial burden of one or more local authorities or that the risk incurred by those that have given their backing to a local mixed-economy company loan. The regional court of auditors communicates its opinion to the prefect, the local mixed-economy company and the deliberative assemblies of the local authorities concerned within one month (*Code général des collectivités territoriales*: art. L.1524-1). This is obviously not a means of checking legality but a warning mechanism calling on the financial expertise of the regional courts of auditors. The same applies to the option open to the prefect of submitting to the regional court of auditors public-service delegation agreements, which the local authorities must transmit to him for the purpose of checking legality (art. L.1411-18). These provisions supplement those concerning budgetary supervision, which also involves the regional courts of auditors, and budgetary and financial information (see below). In the United Kingdom, the district auditor may also alert the local authorities to the risks of taking certain decisions; he refers the matter to the courts if these decisions go beyond the powers which are conferred on the local authorities.

In Poland, there are also regional courts of auditors (Act of 7 October 1992); they give an opinion, if the work has not been carried out, on the possibility of financing it and on the lawfulness of forecasts relating to the level of local authority debt; a negative judgement obliges the latter to re-examine the corresponding budget. The regional courts of auditors also issue a judgement on the draft deliberation on the state of the authority's assets. Finally, if a local authority plans to take out a loan, to ask for credit or to issue bonds, the regional court of auditors gives an evaluation of its ability to repay the loan or to redeem the bonds issued; this evaluation is intended for the banks or the market authorities. It may be considered, however, that in the latter case there is an inversion of roles because the aim of an intervention of this kind ceases be to protect public finances.

In Croatia the audit office is responsible for searching for and reporting managerial irregularities and instances of poor management, but its work is not geared to risk prevention. On the other hand, the Budget Act obliges local authorities to make internal arrangements for supervision and risk evaluation. Moreover, under the Budget Implementation Act, local authorities must, for each loan, report twice a year, showing that they have honoured their debt repayment obligations and used the funds for the purpose for which they were intended.

B. Controls carried out by the financial bodies

The greater degree of freedom generally granted to the local authorities and the fact that lending has been opened up to non-specialist agencies leads one to expect the financial bodies to carry out, for their own security, their own control of the financial situation of the local

[1] For example, the regional laws of Lower Saxony (§108) and Baden-Württemberg (§102) include the following condition of legality: "2. die Unternehmen nach Art und Umfang in einem angemessenen Verhältnis zu der Leistungsfähigkeit der Gemeinden und zum vorrausichtlichen Bedarf stehen".

authorities wishing to take out a loan. Contrasting practices can, however, be identified. In fact the main variable seems very simple: it makes a distinction between the countries in which, despite the opening-up of lending to non-specialist agencies, specialist bodies retain a very hegemonic position on the market for lending to local authorities and others.

The banks clearly play a minor role in Germany, Belgium, the Netherlands, Denmark and even in the United Kingdom, where evaluation of the local authorities' financial situation by the banks exists but scarcely attracts any interest. In these countries, the specialist agencies cover between three-quarters and the near-totality of lending to local authorities. However, the marginal intervention by commercial banks may change the rules of the game, or at least cause them to be questioned. In Germany, where local authorities in serious financial difficulties may, however, obtain a loan which is underwritten by the *Land* central bank, since the local authorities are considered to be an integral part of the *Land,* they still benefit from its support as a last resort, one notes that some commercial banks doubt the solidity of a guarantee of this nature and the obligation of the *Land* to finance the local authorities' debts, this problem arising mainly in the new *Länder*. However, conversely, this kind of questioning raises doubt about whether many local authorities will apply to the commercial banks to obtain credit.

By contrast, in other countries in which lending to local authorities is a more competitive market, the banks exert a more obvious control on the financial situation of the borrowing authority. In Sweden, despite the extensive fiscal power of the local authorities, it is known that the banks have refused to grant loans to local authorities which, in their view, were borrowing too heavily, whereas in Denmark the same fiscal power is considered to ensure, whatever the hypothesis, the solvency of the local authority and to make risk analysis superfluous. In Norway, but also in Poland, banks assessing the solvency of a local authority wishing to take out a loan refer to the assessment made by the public authority, ie government approval in Norway (a sign of weakness which leads to less favourable conditions) and in Croatia and the opinion of the regional court of auditors in Poland, as we have just seen. In Finland, they are based on the local authority's balance sheet and the accompanying informative notes; but they may also refer to the assessments published by the Statistical Centre of the Ministry of the Interior, the Association of Local and Regional Authorities or research institutions. Besides these criteria and in the other countries, banks analyse the risks as they do for any borrower, but, generally, local authorities, like other public bodies, benefit from a more favourable diagnosis based on the acknowledged fact that the local authority may not be declared bankrupt. It is generally found, however, that the Cooke solvency ratio applied to bank loans to local authorities is between 0 and 20%, whereas it is 0 for governments and 80% for companies. The existence of a special co-efficient bears witness to the fact that local authorities are seen as presenting a special risk[1].

These evaluations have not made it possible to avoid crisis situations, as can be seen in various countries, revealing under-estimation by the lending agencies of the local authorities' financial risks. In France, we are familiar with the crises of towns such as Angoulême and Briançon in recent years, or of mountain areas which committed themselves too heavily in order to develop their tourist facilities. The limits introduced by increasing the fiscal pressure lead to renegotiation of the loan and to delays in the effective payment of the instalments even if they

[1] S Serve, op cit, p.3.

were included in the budget as compulsory expenditure.[1] These are minor examples but others can be found in other countries where the local authorities have comparable freedom in terms of financing. With the internationalisation of loans to local authorities, loan institutions have occasion to lend to foreign local authorities and are less aware of the climate in which these operate. This means that they are more exposed to the risk that the borrower local authority will encounter financial difficulties.

One of the most important risk factors arises from the difficulty of obtaining a consolidated set of accounts for the local authorities – one which includes the risks of many satellite bodies, whatever their status, which, in all of the countries, are set up by the local authorities and placed under their jurisdiction;[2] that includes not only many public co-operative institutions to which the local authorities belong and to which the responsibility for many duties has been delegated, but also operational bodies such as local mixed-economy companies. In France, the Act of 6 February 1992 made it mandatory for an overview of the administrative accounts of the public co-operative institutions in which local authorities are involved to be published, and the consolidated statement of the results of the general budget and the subsidiary budgets, which constitutes progress (*Code général des collectivités territoriales*: art. L.2313-1), but not all the satellite bodies are run on the basis of a subsidiary budget. It is also compulsory to publish details of aid provided to associations, the most recent certified balance sheets of bodies in which the municipality has a holding or for which it has guaranteed a loan or paid a subsidy exceeding FF 500 000 or accounting for more than 50% of the receiving body's budget, and the amount of the loans guaranteed (ibid). In Sweden municipalities have been obliged by law since 1992 to submit consolidated accounts including housing associations and energy companies (in proportion to the municipal holding), with the result that the scope of the consolidated accounts is such that the municipality's financial situation can be assessed very effectively[3]. Neither does German legislation make it compulsory to present consolidated accounts; however, there is frequently an economic grouping of different public enterprises which run the local public services. In other cases, there seems to be no consolidation of the accounts, which makes it difficult to assess the risks.

Moreover, the tendency, encouraged by the vogue of new public management, to outsource many functions or to organise them according to a corporate design permitting their receipts and expenditure to be defined individually, leads to a fragmentation of local authority services, which might make it difficult to assess the local authority's overall financial situation. At most, the progress made in improving the management of each service might make it more difficult to steer the whole.

Finally, the practice of rating local authorities has clearly been spreading for some years; this has been carried out for a long time in the United States, where the local authorities are used to encouraging the public to save by issuing bonds, which, in the United States, benefit from attractive tax concessions.[4] Rating expresses a financial assessment relating to the reputation –

[1] Samuel S. Theodore, op. cit. p. 146.

[2] On this longstanding problem, see: Jean Bouinot, *La nouvelle gestion municipale*, Paris, Cujas, 1977; J. Dupuis, "Consolidation des comptes des collectivités locales et contrôle de gestion", *Revue française de Finances publiques*, 1991, no. 34.

[3] S Serve, op cit, p. 74.

[4] E. de Bodart, "La pratique de la notation des villes aux Etats-Unis", *Revue française de Finances publiques*, 1990, no. 30.

which may vary – of the local authority wishing to issue securities. The rating reflects not only the risk that the borrowing authority will go bankrupt, which is unlikely, but also the liquidity risk facing certain local authorities. The market also takes account of this risk. The rating given by an independent board is a reference for investors; however, with regard to the financial situation of the local authority, it is related to the envisaged issue rather than to the local authority itself in a broader sense. Although rating can be a means of improving the local authority's credit with the banks, it is only really of interest for local authorities which issue bonds.[1] This means of financing is not practised in all European countries; it does not seem to be used in Belgium, Denmark, Portugal or Poland (where, however, some towns have issued bonds). It is used most often in France, Italy, Spain and Sweden, which explains why rating is more common there than in the other countries[2]. Nevertheless, relatively few ratings are carried out[3]. In other countries where the local authorities prefer to take out a bank loan – particularly in the United Kingdom, Norway, Germany and the Czech Republic – only some have requested a rating. The practice of producing standard ratings, ie ratings designed not to support a bond issue but to provide a summary diagnosis of the financial situation of a local authority seeking a bank loan, is, however, tending to become more widespread in Europe.

Stéphanie Serve's detailed study of rating techniques throws up several interesting conclusions. It is possible to assess the degree of risk on the basis of a small number of criteria, but the rating does not reveal new information since it uses public data. The rating discrepancies between agencies draw attention to the omission of certain variables, however. The author shows that it is possible to improve the predictive reliability of the rating by combining socio-economic variables with financial and fiscal indicators. She considers that it is possible to devise comparable risk indicators for the countries of central and eastern Europe, which would make it possible to anticipate the risk of bankruptcy[4].

Rating does however raise one basic issue, even though it must be acknowledged that in the event of a bond issue it is only natural that local authorities should be subjected to the same rules as other issuers. As a result of the spread of this practice, banks are classifying requests for financing from local authorities according to financial market criteria rather than in terms of the needs which the funds are required to cover, and making credit more expensive for local authorities which might be most in need of it. In the long run a development of this kind could lead to the restoration of a system of preferential loans for local authorities, at least those whose financial situation is the least favourable.

To avoid this, several countries have deliberately devised strategies to ensure that all local authorities have access to the same rating system. In the Netherlands this system is based on a set of rules governing local authority borrowing, designed to eliminate the risks involved, and on the fact that the central bank applies a zero risk rating to loans granted to local authorities; at the same time, rating agencies grant a triple A rating to credit institutions that specialise in lending to local authorities or bodies answerable to them[5]. The United Kingdom has the same

[1] Cf. Michel Bouvier, *Les finances locales*, Paris, LGDJ "Systèmes", 6th ed. 1999, p. 166.

[2] S Serve, op cit, p. 7.

[3] According to Stéphanie Serve, the Standard and Poor's Agency carried out 52 ratings in 1998, including 13 in France, 12 in Italy, 11 in Spain and 10 in Sweden; in the same year the Moody Agency carried out 26 ratings in western Europe, including 7 in France, 6 in Italy, 10 in Spain and 2 in Sweden (op cit pp. 236 and 238).

[4] Above-mentioned thesis, pp. 202-269.

[5] *The creditworthiness of Dutch municipalities*, Ministry of the Interior, Ministry of Finance of the

objective. The role of the Public Works Loan Board as a lender of last resort helps to achieve it, since it ensures that local authorities can obtain loans and protects the lender against bankruptcy on the part of the borrower. In the case of large local authorities that borrow on the market, the Treasury and the Bank of England influence the rating with their own assessments and comments. In France the warning system set up by the government is similar to a public rating system; its influence on rating agencies has yet to be assessed.

C. Internal organisation of financial management and follow-up methods

It is first the responsibility of each local authority to organise the finance function within its services in such a way as to ensure that management avoids exposing it to excessive risk. The wide range of financial instruments and the complexity of transactions relating to urban redevelopment or infrastructure development require specific qualifications and call for effective account to be taken of risk assessment when preparing decisions. The European Commission sets great store by the progress made in this respect in countries receiving financial support from it. Only fairly general observations are available on this matter but they suggest that greater account is taken of this function. This can be seen particularly in Ireland, Germany, France, the Netherlands, Denmark, Norway, Finland, Poland and Croatia, where the law imposes it to local authorities, both within local authority services and by the use of specialist consultants. By contrast, according to the responses which it was possible to collect, this function is rare in Belgium, the United Kingdom, the Czech Republic and Russia.

Progress in this area implies guidance and support from the state, greater awareness of the stakes on the part of the local councillors and training schemes suitable for executives in the regional authorities' financial services.[1]

An important contribution by the state or local authority associations to improving risk management may be to draw up and propose follow-up instruments and instruments to analyse the financial situation, which, if used by all the authorities or most of them, allow unusual developments to be identified.

In France, financial analysis based on the ratio method has been developed extensively on the basis of the series of ratios worked out by the Directorate General for Local and Regional Authorities at the Ministry of the Interior which give rise to the annual publication of *Ratio Guides*, with the averages of these ratios by demographic category of municipality and by region, distinguishing between the situation of isolated towns, centrally situated towns and satellite towns (at least for municipalities of more than 10,000 inhabitants). Apart from the two ratios relating to the budget volume per inhabitant, five series of ratios can be distinguished which relate to the service rendered (5 ratios, including, for example, the actual operational expenditure per inhabitant), operational income and savings capacity (18 ratios, including, for example, the actual operational income per inhabitant, and the revenue from four direct taxes related to fiscal potential), facilities and financing (11 ratios, including, for example, gross

Kingdom of the Netherlands, The Hague, 1999, in particular pp. 6 and 21.

[1] René Verstraete, "Besoins de formation à la gestion financière des cadres territoriaux", pp. 227-241 in: Alain Guengant, op. cit.

expenditure of plant and equipment per inhabitant), the burden of debt (10 ratios, including, for example, the unadjusted annuity on the debt over the current financing capacity), and finally the room for manoeuvre and equity management (5 ratios). The latter best clarify the situation of the municipality (*commune)*, from the perspective of public activity. The publication of these ratios allows the municipalities to gage their position as compared with the average situations and to analyse the reasons for discrepancies. It also contributes to the warning system set up by the government (Public Accounts Directorate of the Ministry of Finance) to detect risk situations quickly and take the necessary action. This system seems to be unique in Europe. It is based on four criteria: self-financing margin, tax-raising capacity co-efficient, inflexibility of committed costs and indebtedness. These criteria give rise to a comparison with the warning thresholds established at national level, which can be modulated according to demographic category: when three thresholds are crossed, the situation is deemed "critical", and when all four thresholds are crossed it is considered to be "extremely bad". The Directorate General for Local Authorities adds three criteria for municipalities with over 10 000 inhabitants. The diagnosis leads to a rating in the form of a letter, which is communicated to the mayors of the municipalities concerned[1].

Certainly the limitations of the ratio method are known: it does not cover extra-budgetary financial data, except in part and indirectly via transfers from the operating section, plant subsidies et annuities on loans; it does not reflect special situations connected with the population of a municipality (eg seasonal population, demographic structure); it presents an immediate picture but excludes developments. Taking the ratios as a basis, it can nonetheless be supplemented to a certain extent by analyses over time, and especially detailed analysis of the ratios in relation to the room for manoeuvre. Some ratios also have legal significance: those – 11 of them – which must be published with the budget documents by every municipality with 3,500 inhabitants and more (*Code général des collectivités territoriales*: art. R.2313-1). The Czech Republic appears to be moving in that direction, with the definition of criteria which act as a basis for the assessment of the financial situation of the local authority with regard to the allocation of subsidies.

It is common practice to determine follow-up *indicators* of the local authorities' financial situation, which act as a basis for various decisions concerning the local authorities, and some may have legal bearing. However, it does not seem as if other countries, within the scope of this study, use a follow-up method of financial situations based on a standard set of national ratios.

D. Information of local councillors and citizens

Democratic debate is also a means of averting financial risk as it gives critics the opportunity to voice their opinion and to ask questions about decisions which may expose local authority finances. That implies that they have access to financial information and that the relevant information has been published. Budgetary documents are now made public in all the countries but, apart from this minimum requirement, the statutory provisions generally seem inadequate.

[1] S Serve, op cit, pp. 76 ff.

One of the most interesting approaches is that adopted by the Netherlands. In that country, an accounting system has been introduced into the local authorities that is similar to that used by enterprises, and since 1995, the balance sheet presented to the municipal council must be accompanied by a report on financial risks. This must, in particular, analyse the risks which do not appear in the balance sheet figures; these risks may not always be quantified but are likely to have an impact on the local authority's financial situation. However, only quantifiable risks call for reserves to be set up. In practice, use of this instrument is encountering difficulties, but the Ministry of the Interior and the regional authorities, which are responsible for supervising the local authorities, aim to develop the local authorities' risk management ability.

In France, progress has been made mainly in the field of information or transparency, in particular since the Act of 6 February 1992. Information made available to the public is defined in detail by the Act; it must permit an opinion to be formed about the management and financial situation in the municipality. It is indeed important not to leave the selection of information to be published to the discretion of the local authority, since the latter could easily steer the assessment of the citizens and the local councillors. Pursuant to article L.2313-1 of the *Code général des collectivités territoriales*, the following documents must be appended to the budget documents made available to the general public:

- "synthetic data on the financial situation of the municipality" (the ratios referred to in article R.2313-1, and the number of second homes in tourist resorts or health spas);
- the list of assistance granted by the municipality to associations (in kind or as subsidies);
- the consolidated statement of the results of the last financial year covered by the general budget and supplementary budgets;
- tables resuming the administrative accounts of the public institutions for inter-authority co-operation in which the municipality is a member;
- the certified balance sheet for the last known financial year of the bodies in which the municipality holds an equity share, of which it has backed a loan or to which it has paid a subsidy;
- a table showing the liability of loans guaranteed by the municipality, with the relevant repayment table;
- the accounts and supplementary documents which the assignees of public service are obliged to present to the delegating authority;
- the table of real-estate acquisitions and transfers.

A decree has stipulated the details of the different budget and accounting concepts which act as a basis for the preparation of all these documents.

In the United Kingdom, efforts have been applied mainly to performance in the management of services. The Audit Commission has systematically developed benchmarking between the local authorities and follow-up by management indicators which have been put in place for the different services on the basis of "citizens' charters", but it is only of incidental interest with regard to financial risk. On the other hand, it is now one of local authorities' main obligations to publish performance indicators. In March every year they must publish their "best value performance plan", which is intended to give substance to local government officers' public accountability. A new White Paper setting out means of increasing local government officers' accountability is expected towards the end of 2001. In Croatia the Ministry of Finance publishes statistical data on local finance, including detailed information on individual local authorities, on its website.

2. Risk spreading

A classic method of reducing risk is of sharing it out among several parties within the framework of a co-operative venture. This corresponds to the practice of "round table" meetings, commonplace in private business, but which has also become widespread in public-sector activities in many countries. The success of the "partnership" between public bodies or with private companies bears witness to this. No mistake should be made about the meaning of this term: partnership is an expression of agreement, suggesting harmony between the "partners". However, it also implies solidarity between the partners and that solidarity can also be a risk for the local authorities.

However, some of the risks may also be transferred to the users, if they are captive, or to the state, if it intervenes *de facto* as a guarantor of last resort in the event of exceptional financial difficulties on the part of the local authorities. However, analysing the tariffing of public services from the perspective of risk would require more precise information about regulation and tariff policies. One would also have to examine the role which insurance might play, but there are insufficient data for this. As to the role of the guarantor of last resort which may be played by the state, it is discussed in the report on *Financial risk.*

This study will therefore only examine risk-sharing between public bodies and public-private partnerships.

A. Risk sharing by public bodies

Risk sharing works via different types of cooperation, horizontal or vertical, between local authorities, as permitted under the laws of each country. This cooperation allows an undertaking to be coordinated and resources to be pooled, which implies cost sharing; the risks are thus shared out among the parties to the cooperative venture. The local authority syndicate, whatever it might be called, is the simplest and the most classic way of sharing risk; it is particularly useful in countries in which the local authority structure is considerable fragmented in terms of the areas covered. However, there are also agencies with the status of commercial societies, of which the local authorities are the shareholders, therefore bearing the risk of the company in their budget on a pro rata basis according to the degree of their participation. This type of cooperation is too well-known to make it appropriate to go into lengthy detail here. However, it seems to be relatively underdeveloped in the countries of central and eastern Europe characterised a high number of small municipalities, and where it would be useful to promote its development (Czech Republic, Hungary, Slovakia). Moreover, its development is sometimes the indirect consequence of measures which had other objectives: for instance, in Norway, the development of financial cooperation agreements between municipalities has been observed since they have ceased to be allowed to guarantee their enterprises, by virtue of an act dated 1993; an alternative solution is to set up a kind of financial cooperation which share and spreads the risks of the different companies.

More interesting and more recent is the development of co-operation agreements relating to a particular programme or project, and their joint financing by several public bodies. Especially with regard to major projects, which are expensive and, by nature, risky, this procedure presents many advantages, beyond that of co-ordinating decisions.[1]

- from the economic point of view, it is a flexible response to the existence of reciprocal indivisibilities, complementarities or externalities relative to the supply of some goods with in a given field; it is a (more or less) negotiated method of cost sharing
- from the political point of view, the contract securities financing, insofar as the result of negotiation is more difficult to challenge than a unilateral financing decision; it reveals the preferences via the emerging interest shown in participation and finally the contract-based co-operation raises the risk threshold acceptable to each of the parties, which makes it possible for several to be involved in something which would not have been possible for one of the parties on its own.

This technique has been developed on a large scale in France on the basis of state-region development contracts, extended by specific contracts relating to particular operations. It has been applied, beyond development contracts, to the financing of large facilities such as the city-centre station of the TGV Nord in Lille, or integrated into the development contract as for the urban redevelopment project in Marseilles, which, in turn, is based on two major long-term projects, the "major city project", which deals with the run-down districts in several administrative areas (*arrondissements*), and Euroméditerranée, which gives its name to the public institution responsible for operating the redevelopment agency co-financed by the government, the city, the region and, more recently, the department; the chairman is the deputy mayor of the town, while the managing director is a civil servant appointed by the government.

Other countries have taken a pragmatic approach to procedures of the same nature. It is the case of development agreements and covenants foreseen by Act No. 142/1990 in Italy (art. 24 and 25),[2] particularly with regard to the completion of infrastructure or redevelopment activities, sectoral agreements and joint plans or programmes of the state and the autonomous communities in Spain, foreseen by Act No. 30/1992 on the system of public administration and the common administrative procedure (art. 5 and 7); similar are the "joint missions" of the Federation and the *Länder* foreseen in article 93a of the Basic Law and the "contract-based agreements" relating to the implementation of plans to redevelop land which are becoming more widespread in Germany, with no explicit legal basis, and some can involve joint financing.[3] The Polish Act of 12 May 2000 on regional development also allows for regional development contracts to be signed between the government and the *Voïvodes* (regions), determining the programmes and the financing agreements entered into by the parties. These are modelled on French development contracts but are set in a more detailed legal framework; it was tried out for the first time with the contract signed in 1995 for the Katowice region.

[1] For a legal and political analysis, see: G. Marcou, "La coopération contractuelle, la ville et le droit", pp. 47-155 in: G. Marcou / F. Rangeon / J.-L. Thiébault (ed.), *La coopération contractuelle et le gouvernement des villes*, Paris L'Harmattan, 1997, and Jean-Pierre Gaudin, *Gouverner par contrat*, Paris, Presses de Sciences Po, 1999; for a sociological and economic approach, see: Marc Leroy, *La logique financière de l'action publique conventionnelle dans le contrat de plan Etat-région*, Paris, L'Harmattan, 2000, and Guy Gilbert / Jean-Claude Thoenig, "Les cofinancements publics: des pratiques aux rationalités", *Revue d'Economie financière*, no. 51, January 1999, pp. 45-78.

[2] Paolo Sabbioni, "Les accords entre administrations dans le système juridique italien", pp. 317-346, in: G. Marcou / F. Rangeon / J.-L. Thiébault (ed.), op. cit.

[3] Willy Spannowsky, *Verwirklichung von Raumordnungsplänen durch vertragliche Vereinbarungen*, Bonn, Bundesamt für Bauwesen und Raumordnung, Forschungen no. 93, 1999.

B. Public-private partnerships

The public-private partnership is a complex concept, its ambiguity serving to explain in part why it has been so well received. One never knows, in fact, if it is a new term used to designate practices which have existed for decades, or if it is intended to express a new philosophy governing relations between the public authority and private companies in carrying out responsibilities which are the remit of the former; nor is it any clearer whether it is another form of privatisation or a way for the public authority to retain fundamental powers. There is no satisfactory definition of what it is, apart from the fact that it implies cooperation and a certain duration and that the partners expect to achieve something that they would have been unable to achieve alone.

These ambiguities can only be noted; they cannot be resolved in this report. From the perspective of the local authorities, the public-private partnership is only of interest from the perspective of financial risk. The public-private partnership is in fact often presented as the way to improve the standard of the facilities and the quality of the services while reducing the burden on the public budget. These objectives would be achieved thanks to the greater efficiency of private management and by transferring the risk to the private partners. For example, in the United Kingdom, the explanatory note of the Department of the Environment, Transport and the Regions entitled *Local Government and the Private Finance Initiative* states that the measures tending to facilitate use by the local authorities of the PFI and other forms of partnership set out to promote private investment in the building of infrastructures necessary to public services on the basis of "risk-taking", and to achieve better value for money by allocating the risks to those that are best able to assume them – in the public or in the private sector public.[1] One of the functions fulfilled by any contract – and the partnership is based on contracts – is to spread the risks between the parties.

However, ambiguity springs from the fact, as Jean-Michel Uhaldeborde has clearly shown, that if the public-private partnership is the outcome of cooperative strategies on the part of the public authority and on the part of the companies, it also gives rise to non-co-operative behaviour.[2] This occurs if there is an imbalance of powers between the private enterprise and the local authority and limited competition; imbalance is, in particular, the outcome of information asymmetry between the partners. To put things right, the legal framework of the partnership, pricing policy and the conditions of control and audit would have to result in the companies communicating correct information. The establishment in 1995 by the Association of French Mayors of an advisory association for local authorities (*Service public* 2000) to assist them in their relations with large groups was going in the right direction. However, a balanced relation also implies a political will – which has often been lacking. In France, where local authorities have long delegated to private companies the management of most of the industrial and commercial public services, the local councillors have tended to consider that they were no longer responsible for that service,[3] whereas the law and jurisprudence acknowledged that they

[1] Published on 22 September 1998, accessible on the DETR website: http://www.local-regions.detr.gov.uk/pfi/2.htm

[2] Jean-Michel Uhaldeborde, "Partenariat public-privé et efficacité économique: les aléas d'une complémentarité antagonique", pp. 65-79 in I. Chatrie / J.-M. Uhaldeborde (ed.), "Partenariat public-privé et développement territorial", *Revue d'Economie financière*, special edition, 1995.

[3] Dominique Lorrain, "Le modèle français de services urbains", *Economie et Humanisme*, no. 312, pp. 39-58.

had extended powers to steer and control; at best, negotiating contracts was one way of procuring extra resources for the local authority by obtaining payment of high admission fees, which led to tariffs being set above the cost of the service rendered, a practice condemned by the administrative judge, at least if he has been involved.

Moreover, if the contract transfers the risks to the private operator, the political responsibility of the local authority should not oblige it to accept the return of the risks should the operator default or circumstances change.[1] In fact, if the contract distributes the risks, the function, by nature, sometimes produces a solidarity between the local authority and the private operator. In principle, a contract delegating public service provides for the use and, where applicable, for initial investment, at the cost and risk of the assignee (traditionally the franchise holder), or only partially at its risks, depending on the responsibilities or guarantees the public authority agrees to cover. In many cases the outcome is in fact a negotiated sharing of responsibilities and risks, depending on the nature of the service (under the conditions defined by the public authority) and the market. However, circumstances may challenge that sharing to the detriment of the local authority if they affect the use of a structure or service which may not be interrupted; the local authority may then be led to accept the costs which should have been borne by the assignee or his financial backers. The solidarity between the partners, to maintain the service, thus prevails over the strict allocation of the risks on the basis of the initial terms of the agreement. Failing this, the local authority is led to assume responsibility again for use. These difficulties, and the crisis of a certain number of franchises for public services during the Third Republic, explain the tendency to “publicise” the franchise holders which has been evident since the end of the second world war, at least in some sectors.

The case of the concession for the city ring road in Lyons is a good example: it was badly received by the users who contested the principle and the level of the tolls, and then got the administrative judge to cancel the concession on the grounds of the failure to comply with the local authority directive on the handover terms applicable to the labour markets; in the end, the urban community in Lyons had to buy back the concession and cover both the indemnification of the franchise holder and repayment of the investment; of course, the structure could not be closed to traffic. Similarly, the automatic underground link, Orlyval, between the southern line of the RER in Paris and Orly airport is the subject of a franchise contract for its construction and its operation, on the basis of non-recourse project financing. Unfortunately, errors in forecasting the traffic were such that the operation condemned the franchise holder to bankruptcy less than one year after the structure was opened. The way out of the crisis is tantamount to nationalisation, the RATP having taken over again the operation of its own network, whereas the Ile-de-France region agreed to finance half of the annual investment expenditure necessary for this operation. In that case, the banks lost the most, having to give up most of their claims in return for a risky participation in the operational revenue above a certain threshold.

This last example is particularly interesting: project financing seems, in theory, to be well suited as a means of financing franchised structures, since operation then guarantees foreseeable revenues which will be able cover repayment of the loan; the lender then does not then use public sector assets as real-estate collateral, which is not, in principle, permitted anyway. However, according to the responses to the questionnaire, project financing is little

[1] For further details, see: G. Marcou, “L’expérience française de financement privé des infrastructures”, op. cit., especially pp. 94 f.

known and little used at the level of the local authorities in Europe. It can also be clearly seen that the examples given are such as to encourage the banks to be prudent, such as, moreover, the example of the Channel Tunnel, from which the Orlyval franchise was directly derived. Hence for Patrick Ponsolle, the former director of Eurotunnel, "to effectively relaunch public-private partnerships implies, in reality, mobilising more public-sector funds" and he refers, as an example, to the building of the high-speed train link between Folkestone and London, more than 50% of which will be funded by public money.[1] In other words, for industrialists and banks, a public-private partnership is not intended to be a means of shifting all the risks onto the private partners; rather, it implies that it is necessary to define clearly which risks and responsibilities are borne by the public authority and which by the private partners. Consequently, for the local authorities, public-private partnerships are not a way of avoiding risk, but another way of defining and assuming it.

This is particularly true of major urban development activities, which imply a certain solidarity between the public authority and the public or private developers, for better or for worse. The difficulties encountered since 1990 in the project to develop the Berlin-Adlershof district illustrate the point. The plan was to develop, by 2005, a new district dedicated to science and technology, with a vast activity area, a "media city", housing areas, a science campus for Humboldt University and a landscaped garden. The *Land* of Berlin made the necessary arrangements for this project to be carried out by setting up development companies under its management to plan and run the structure and took out the loans needed to finance the work, with repayment being ensured by selling the land back to the developers. But, of course, a project like this was only likely to succeed if it incorporated private-sector investment views, with representatives of the private sector participating from the outset in drawing up the project. The resultant solidarity made difficult any withdrawal when the economic situation became unfavourable and made it illusory to expect the debt to be covered by commercial exploitation of the land; a large proportion of the debt was thus transferred to the budget of the *Land* of Berlin. The limited measures aimed at reducing the ensuing burden on the budget were sharply criticised by the developers involved. As Hartmut Häussermann and Katja Simons wrote, the policy of large projects is also a "policy of large risks"; it is not only exposed to changes in the economic situation, it is also based on a "community of fortune made up of representatives of heterogeneous interest" which is characterised by major inertia. The difficulty of challenging a project, by virtue of the market development, which implicates *de facto* the political responsibility of the elected municipal leaders and as a result of which the private investors have taken risks lead to transferring to the public budget the ensuing losses.[2]

For the public authority, in the end difficulties of this kind always mean increased debt. Ultimately, it is therefore only by providing a framework for the borrowing that risk taking can be restrained. However, it would be just as counter-productive to rule out risk-taking by local authorities as this would, in fact, tend put a stop to development initiatives, or to reserve them for the central government, which would run counter to the generally accepted freedom given to local authorities to develop their territory. However, public authorities are then perhaps not justified in functioning as the private investors' underwriter. Conversely, it is felt, even if it is not expressed, that a public guarantee will always work if the public authority is politically active, which may lead the private sector to accept risks which it would perhaps not have taken in a purely market context.

[1] Patrick Ponsolle, "Le financement privé des infrastructures", *Revue d'Economie financière*, no. 51, January 1999, p. 134.

[2] Hartmut Häussermann / Katja Simons, "Die Politik der großen Projekte – eine Politik der großen Risiken?", *Archiv für Kommunalwirtschaft*, 2000, no. 1, pp. 56-71.

CONCLUSIONS

The previous observation outline two basic points. On the one hand, the legal provisions in force relating to the regulation or management of risk frequently lag behind the development of those risks which the local authorities are likely to take, and frequently reflect earlier or traditional concerns of the system used to control local finance. The comparison shows that the areas or the risks to which these controls apply vary considerably from one country to another, although no explanation can be found for this other than historical development. In certain cases, there seem to be gaps in the regulations, exposing the local authorities to risks, although, more often than not, customary practice has prevented these risks from arising. On the other hand, however, the local authorities generally seem to be very careful and new risks arising from new methods of carrying out and financing some of their activities arise fairly infrequently because local authorities rarely make use of them. Apart from some outstanding examples, most local authorities remain faithful to the management and financing methods with which they are familiar. However, new policies which resort to public-private partnerships as a means of financing infrastructure or urban development may generate major risks, some examples of which, in the countries of western Europe, show that they are difficult to manage.

One might attempt to formulate a certain number of general principles, many of which are already applied in different countries, although not in all, and which may result in rather different legal rulings. Account must be taken, in particular, of all the rules applicable in a country, since the same result may be achieved by means of very different combinations.

1. Current expenditure must be financed out of permanent funds, except for using cash advances and short-term loans in exceptional cases, and borrowing must be used only to finance investment expenditure.

2. The use of financing techniques which have the effect of concealing the level of debt of the local authority must be prohibited; all financing techniques must be subjected to conditions which re-establish the transparency of its financial situation or limit the risks involved.

3. If the use of municipal real estate as collateral may endanger the fulfilment of local authorities' tasks, especially in case of assets earmarked for the performance of the local authorities' duties, the use of such collateral must be prohibited, at least in those countries in which their capital resources are weak and little likely to grow.

4. The freedom to resort to borrowing in order to finance investment expenditure may increase in proportion to the size and growth of the capital.

5. The presentation of the budget and accounts must give as complete and realistic a view as possible of the local authority's financial situation. That implies working towards drawing up consolidated accounts, integrating the results and showing the risks of the different satellite agencies and the local authority's obligations to them.

6. The presentation of the budget should be accompanied by an analysis of the financial risks to which the local authority is exposed, the quantifiable risks giving rise to setting up reserves, while the degree of exposure to non-quantifiable risks should be estimated.

7. In those countries in which the local authorities are at liberty to deposit their funds as they deem appropriate, a system of insurance or re-insurance is needed to protect the local authorities against the loss of some of their assets in the event of bankruptcy of their bank.

8. Guarantee or guarantee deposit obligations must be published, with a distinction being made between the obligations over the financial year, the loans outstanding and the costs arising from these guarantees; the use of prudential ratios to limit these risks is to be recommended.

9. If they expose the local authority to important financial risks, establishing or managing business enterprises, or participation in such enterprises must be limited, in principle, to public service activities or to the situations in which the sharp deterioration of the economic situation and employment justifies exceptional and short-term public intervention; they should not aim to procure extra financial resources for the local authority, these usually being only incidental or accessory in nature.

10. Speculative investments must be prohibited.

11. In order to reconcile the need to protect public finances with the autonomy of the local authorities, legislation should prefer, whenever possible, to set up warning procedures rather than supervisory mechanisms, and overall regulation rather than a control of individual activities.

12. It is appropriate to foster the setting-up of follow-up systems and ratios, the largest of which must be made public so as to enable the financial situations to be compared and the divergences to be analysed and to prevent risks. This information will also provide food for thought for authorities considering the advisability of certain commitments, facilitate public scrutiny and provide an objective basis for government supervision.

13. It is appropriate for the local authorities to acquire, individually or collectively, the expertise necessary to manage risks arising from their financial obligations; that expertise may involve training financial executives of local administrative bodies, the state services or the independent public audit bodies (for example, regional courts of auditors), the associations of local authorities and the private sector on a market basis.

14. Horizontal and vertical co-operation between public authorities must be encouraged to facilitate the completion of major projects, in such a way as to share the expenses and the risks, especially in countries with a more fragmented territorial structure.

15. In public-private partnerships, it is appropriate to ensure that the risks are shared out realistically; in particular, an explicit public guarantee is preferable when the nature of the structure or service is such that the local authority may find it difficult to put its future in the hands of the user; it is also appropriate to prevent public intervention from becoming a guarantor of risky private investment.

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