

MELAKA

Demonstrating Fiscal Sustainability



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Sustainability Outlook Diagnostic
Supporting Report 6

MELAKA

Demonstrating Fiscal Sustainability

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Abbreviations

PPIAF	Public-Private Infrastructure Advisory Facility
PPP	public-private partnership
SWOT	strengths, weaknesses, opportunities, and threats

Introduction

Capital investment is essential for achieving sustainable cities. As pointed out by other analyses in this sustainability outlook diagnostic, Melaka State’s long-term sustainability can be improved through well-planned investments in various projects, such as the development of ports and rail connections, a robust public transportation network, and adequate flood prevention. All of these projects will require capital. Although financing provided by Malaysia’s federal government is important, Melaka State’s ability to shape its own investment priorities and accelerate the fiscal improvement process can be greatly enhanced by accessing market-based financing—whether through long-term debt financing, public-private partnerships (PPPs), land value capture mechanisms, or a combination of these.

Fiscal sustainability is the key to accessing adequate capital resources for Melaka State’s investment projects indicated in the State Structure Plan. Fiscal sustainability means the ability to pay for the delivery of adequate ongoing administrative and urban services, while also investing in infrastructure maintenance and improvements so as to sustain foreseeable growth in the demand for services. A fiscally sustainable state or city will have a track record of successfully managing its debts and other financial obligations, along with well-established policies and procedures governing financial management.

This supporting report reviews the fiscal sustainability of both Melaka State and one of its municipalities, Melaka City.¹ The report does not attempt to assess the broader national fiscal and financial arrangements for funding of local capital projects. This initial analysis was proposed by the mayor of Melaka City and focuses on both the state and municipal jurisdictions because some of the investments required to improve the state’s sustainability may have to be undertaken directly by the municipal government. A three-day rapid assessment was conducted in November 2017 to inform the analysis presented in this report. Officials from both Melaka State and Melaka City were interviewed during the rapid assessment, and all financial data is drawn from the official audited financial statements of both governments for years 2012, 2013, 2014, and 2015 (the latest data available during the assessment).² Although the broader Malaysian fiscal and financial environment surrounding the state and city is not analyzed here, readers should consider this report in that context.

The report elaborates the following key message:

6-1 Demonstrate overall fiscal sustainability.

The report concludes by offering several key recommendations that Melaka State and Melaka City could take in order to improve their fiscal sustainability. The recommendations are as follows:

For Melaka State:

- 6-A** Obtain a credit rating.
- 6-B** Improve debt management.
- 6-C** Undertake a concerted effort to increase the state’s own-source revenue.
- 6-D** Achieve a reliable operating margin surplus.

¹ This supporting report will refer to Melaka State and Melaka City. Melaka State is the subnational government with jurisdiction over Melaka City as well as other territory; it is officially known as Negeri Melaka. Melaka City is the subnational government known as Majlis Bandaraya Melaka Bersejarah, or MBMB.

² See Ketua Audit Negara Malaysia (2014, 2015, 2016); State Government of Melaka (2014, 2015, 2016).

For Melaka City:

- 6-E** Obtain a credit rating.
- 6-F** Improve debt management.
- 6-G** Work closely with Melaka State to prepare the city’s own multiyear capital investment plan.
- 6-H** Substantially increase recurrent own-source revenues and reduce reliance on non-recurrent revenues.
- 6-I** Return to maintaining an operating margin surplus.

The report begins with an outline of the strengths, weaknesses, opportunities, and threats (SWOT) related to Melaka’s fiscal sustainability (box 1). It next identifies the basic indicator for measuring fiscal sustainability: the governments’ credit ratings. It then offers preliminary reviews of fiscal performance in revenue generation, expenditure management, and debt management. These reviews are not intended to present an in-depth examination of these topics, but rather to offer an entry point for further discussion.

Box 1 Melaka’s Fiscal Sustainability: SWOT Analysis

The four quadrants below summarize the SWOT analysis for the combined fiscal sustainability of Melaka State and Melaka City. A further elaboration of each item is included in annex B.

Strengths	Weaknesses
<ol style="list-style-type: none"> 1. State: Fiscal framework is sound; revenue sources exhibit flexibility and resilience. 2. State: Debt management policies are adequate. 3. City: Own-source revenue performance is good. 	<ol style="list-style-type: none"> 1. State: Operating revenues are decreasing while operating expenditures are increasing. 2. State: There have been debt management problems in the past. 3. City: Operating revenues are decreasing while operating expenditures are increasing. 4. City: Reliance on sale of assets for own-source revenue generation is too great.
Opportunities	Threats
<ol style="list-style-type: none"> 1. State & city: Domestic sources can provide long-term financing for infrastructure. 2. State & city: Domestic credit rating agencies can provide national scale credit ratings to demonstrate state and city creditworthiness to the domestic financial community. 	<ol style="list-style-type: none"> 1. State: Deteriorating operating margin will prevent financing of infrastructure improvements. 2. City: Deteriorating operating margin will prevent financing of infrastructure improvements. 3. State & city: Grants and loans from federal government and donors may be insufficient to build infrastructure required for sustainability.

Key Message 6-1: Demonstrate Overall Fiscal Sustainability

As with other forms of sustainability, the first step in the process of assessing and improving fiscal sustainability is understanding, measuring, and tracking it. The most useful tool for measuring a city's fiscal sustainability is its credit rating. This provides a creditworthiness score with a standardized and forward-looking external assessment of financial conditions that can be consistently tracked over time and benchmarked against similar cities. Credit ratings are based on analysis that goes beyond the data provided by yearly audited financial statements. The rating is a professional assessment of whether the city is able and willing to meet its commitments to investors providing infrastructure financing. The financial community and private investors use ratings to determine the level of risk involved in providing infrastructure financing—the lower the level of risk, the more available and affordable the financing.

Unfortunately, neither Melaka State nor Melaka City currently has a credit rating. In addition to international and regional rating agencies, there exist two Malaysian credit rating agencies that use a Malaysian national rating scale and that could provide ratings for Melaka State and Melaka City. The rating scale compares creditworthiness among Malaysian corporations against securities issued by the federal government of Malaysia. It is reported that Melaka City did obtain a credit rating in 2009 in preparation for issuing a *sukuk* (Islamic bond), but the rating was not kept current and eventually lapsed after the city decided to not issue the *sukuk*.

Not having a credit rating is unfortunate because attracting market-based financing depends on convincing members of the financial community that they can earn a profit with an acceptable level of risk by participating in the state's or city's infrastructure financing. This is possible only if the state or city is shown to be financially sustainable in the long term—i.e., if it is creditworthy. Thus to mobilize long-term financing for infrastructure from market-based sources, the state or city should achieve *and demonstrate* its creditworthiness. The most efficient way to demonstrate creditworthiness is with a credit rating. The case of another city's journey to obtaining a credit rating and demonstrating creditworthiness is shared in box 2.

Utilizing market-based financing is important to accelerate Melaka State' and Melaka City's investment in projects designed to build overall sustainability. These include big projects, such as building a new port, and smaller projects, such as improving traffic flow in the historic area of the city. By blending market-based financing with grants and loans obtained from the federal government and international financial institutions, Melaka can undertake more projects sooner than would otherwise be the case. For both Melaka State and Melaka City, however, there are likely to be a variety of legal and regulatory restrictions on long-term financing (whether through debt, PPPs, or other mechanisms) that may need to be dealt with before significant levels of market-based financing can be accessed. For example, Article 111, section (2) of the Federal Constitution of Malaysia (Commissioner of Law Revision, Malaysia 2010) significantly restricts the ability of state governments (and by extension their city governments) to borrow from sources other than the federal government or for periods beyond five years. Such restrictions are not uncommon in countries like Malaysia, and have been successfully dealt with in emerging market countries with a federal form of government such as India and Mexico. The case for permitting state and city access to market-based financing is much more compelling if the state or city can demonstrate its fiscal sustainability with an investment-grade credit rating.

Box 2 Achieving Creditworthiness: The Example of Kampala, Uganda

The city of Kampala, Uganda, recently achieved an investment-grade rating (creditworthiness) by implementing best practice reforms. Preconditions in Kampala were a lot less favorable than those in Melaka State and Melaka City, but the overall background and key issues were fundamentally similar. Uganda has maintained an impressive level of economic growth during the past decade (annual average 7 percent GDP growth since 2007), but the country now needs to tackle bottlenecks in its provision of infrastructure to boost employment and reduce poverty. Population growth and urbanization are currently issues of growing concern.

As the principal urban economy, accounting for approximately 50 percent of GDP, the city of Kampala is central to the Ugandan government in ensuring the country's sustainable development. The city faced multiple problems: poor revenue collection and management, consequent overreliance on transfers from central government, and inadequate policy regimes governing development planning and debt management.

In 2012, to help turn around this situation, Kampala sought assistance from the World Bank in improving its financial management, maximizing revenues, improving debt management performance, and developing a PPP project pipeline. The work was launched in December 2012 with a financial management assessment. The assessment found a recent positive trend in revenue collection by the municipality; but several factors, including inadequate property records, inefficiencies in business licensing fee collection, and manual billing processes, represented a significant drag on revenue growth. It identified the need for improved accounting and monitoring practices and for policy adjustments to accommodate long-term capital expenditure planning with commensurate sources of financing. The assessment was followed by a Debt Management Performance Assessment (DeMPA) in 2014 that made recommendations to aid Kampala as it prepared to access and manage short- and long-term instruments.

The World Bank, in collaboration with the multi-donor trust fund Public-Private Infrastructure Advisory Facility (PPIAF), also funded an independent credit rating, which provided Kampala with an objective benchmark of the gains made under the city's strategic plan. A critical element of this approach was to leverage best practice and experience from other cities in the region to enhance the capacity of the Kampala Treasury Services and Revenue Directorate. The technical assistance in PPP pipeline development focused on helping Kampala build its capacity in identifying optimal projects for this type of financing structure and also solidify the current pipeline.

With World Bank support, a workshop was held in 2014 that generated a draft PPP policy to be inserted into the Kampala strategic plan. The policy regularizes the development and procurement of PPPs to ensure that core factors such as financial viability, competitiveness, and transparent procurement practices are at the forefront of any PPP process. The World Bank also worked with Kampala to identify projects with high levels of viability, including a bus rapid transit system, a hospital, and an expressway.

In successfully implementing these and other initiatives, Kampala has garnered a reputation of being an effective, reformed, and innovative administration. Most importantly, Kampala has been able to achieve its first investment-grade credit rating and is now exploring options for a potential debt issuance to fund its capital projects.

Horizontal Analysis of Credit Ratings

With published credit ratings, Singapore and Izmir, Turkey, are models for Melaka State and Melaka City. Because Singapore is both a city and a sovereign government, it has ratings on both the international and national scales. At the moment, Singapore's international credit rating from all three internationally recognized rating agencies is AAA (the highest possible rating, indicating extremely strong capacity to meet financial commitments).³ Because Singapore is a sovereign government with the power to print its own money, its rating on the national scale (compared to other entities issuing securities in Singapore dollars) would also be AAA(sg).⁴ By comparison, the international credit rating for Izmir is capped by Turkey's sovereign rating of BB+ (a "speculative," non-investment-grade rating). However, on the Turkish national scale, Izmir is rated AAA(tr)⁵ (the highest possible rating on the national scale) by two internationally recognized rating agencies (Fitch and Moody's). It is this national scale rating that should ultimately be compared to future national scale ratings for Melaka State or Melaka City.

The cities of Porto, Recife, and Da Nang , along with the State of Penang, do not currently have credit ratings. However, RAM Rating Services Berhad "ranks" the State of Penang as "robust" based on favorable economic metrics as well as sound financial management with persistent operating margin surpluses and sizeable reserves. There may be a variety of reasons why these entities have not elected to seek a rating, but the most likely explanation is overreliance on higher levels of government that discourages use of market-based financing. Given that Malaysia has an active capital market and a banking sector capable of supplementing federal government financing, Melaka State and Melaka City should obtain national scale credit ratings to demonstrate their fiscal sustainability and creditworthiness. Obtaining a rating would also provide the state and the city with a rating report that accompanies the letter grade and spells out in more detail their financial strengths and weaknesses. The rating report would be a very useful guide to efforts to build fiscal sustainability through improved financial management.

Building Fiscal Sustainability: Explore Avenues for Generating Additional Revenue

Revenue is the lifeblood of local governments. Without adequate revenue, no local government can achieve fiscal sustainability. There are essentially three types of revenues available to local governments: 1) recurrent own-source revenues such as taxes, fees, rents, and funds derived from the sale of goods and services; 2) non-recurrent revenues derived from the sale of assets such as land or other property, or from one-time external grants; and 3) intergovernmental transfers from higher levels of government. Of these, recurrent own-source revenues are generally the most important to the financial sustainability of the local government, since they are not limited by a stock of assets or the potentially unpredictable nature of grants from higher levels of government.

Melaka State needs to generate more recurrent own-source revenue. A review of Melaka State's revenue generation performance over the period 2012–2015 shows the following:

- On average, the state derived 74.3 percent of its total revenue from recurrent own-source revenue (the figure varied between 62.7 percent and 82.7 percent). This is a respectable average, but pushing it higher would make the state more fiscally secure and better able to finance infrastructure development for its broader sustainability.
- Overall revenue was down by 18 percent between 2012 and 2015. This is a significant negative factor affecting the state's fiscal sustainability.

³ The agencies are Fitch Ratings, Moody's Investor Services, and Standard & Poor's Financial Services.

⁴ The code "(sg)" indicates that the rating is set on the national scale (in this case "sg" as in "Singapore"), as opposed to the international scale.

⁵ The code "(tr)" indicates that the rating is set on the national scale (in this case "tr" as in "Turkey"), as opposed to the international scale.

- A major problem has been the consistent decline of own-source revenue, which fell by 21.3 percent over the four-year period. This is a very worrisome trend since it greatly hampers the achievement of fiscal sustainability.
- Transfers from the federal government have also decreased, albeit at a slightly slower pace of 13.6 percent. This trend is also not favorable, both because it reinforces the overall downward trend in revenues and because it encourages a gradual increase in the state's dependence on federal transfers (given that they are decreasing more slowly than own-source revenue).
- On the positive side, it does not appear that the state has resorted to the sale of assets to increase its revenues. Another positive is that the state's principle sources of own-source revenues—the land tax, the sale of goods and services, and receipts from state government agencies—suggest some degree of flexibility and resilience in the state's underlying revenue structure.

It is essential for Melaka State to generate more recurrent own-source revenue to turn around the negative trend in overall revenue performance. It should be noted that the three main sources of revenues have almost always underperformed relative to the revenue estimates made at the beginning of each fiscal year. Melaka State should undertake a serious effort to determine 1) if its revenue billing and collection efforts are performing to the best possible standards; 2) if it is possible to increase land valuations or land tax rates; 3) if the revenue from the sale of goods and services can be augmented; 4) whether receipts from state agencies could be increased; and 5) whether there are any potential new revenue sources (taxes, fees, user charges, etc.) that could be introduced.

Melaka City should increase recurrent own-source revenues, while decreasing non-recurrent revenues. This is evident from a review of the revenue generation performance of Melaka City over the period 2012–2015, which shows several issues affecting its fiscal sustainability:

- On average, the city derived 83.4 percent of its total revenue from own-source revenues and maintained a level of over 80 percent throughout the period. This is a good performance and exceeds the performance of Melaka State on this dimension by 10 percentage points.
- The city has also exceeded the performance of the state by maintaining an overall steady level of revenue generation (even a small 1.8 percent increase) compared to the 18 percent decline at the state level. This has been possible due to a 6.8 percent increase in the city's own-source revenue between 2012 and 2015, despite a 28.9 percent decrease in intergovernmental transfers over the same four-year period.
- However, the sustainability of the city's own-source revenue generation is seriously compromised by its ongoing reliance on non-recurrent revenues from the sale of assets, averaging RM 2.25 million per year over the four-year period (1.4 percent of average total annual revenue over the same period). Since the city's saleable assets are by their nature limited, continued reliance on asset sales as a revenue source is not sustainable in the long run.
- Another problem is that Melaka City is heavily dependent on a single source of revenue: property tax. From 2012 to 2015, this one revenue source has been approximately 10 times larger than the next largest source of revenue, from business licenses.
- Moreover, the property tax base is only scheduled for revaluation every five years, and revaluations have been delayed by order of the state. In fact, city finance officials reported that the 2016 revaluation of properties in Melaka City was the first revaluation after a period of over 35 years.

When a city's revenue structure relies too much on inflexible property tax revenues and sale of assets, it becomes much harder for the city to benefit from its growth and development and to meet residents' and businesses' need for more and improved services. The fiscal sustainability of Melaka City hinges on its ability to substantially increase its recurrent own-source revenues and reduce its reliance on non-recurrent revenues. Melaka City should negotiate with Melaka

State on 1) ways to make the city property tax more responsive to changes in property values through more frequent revaluation; and 2) ways to reduce the city's heavy dependence on the property tax by introducing additional robust forms of own-source revenue based on the volume of tourism or surcharges on existing service fees and tariffs. These changes can be a win-win for Melaka City and Melaka State, since own-source revenue improvement at the city level builds fiscal sustainability that enables the city to play a bigger role as a partner to the state in overall development.

Building Fiscal Sustainability: Improve Operating Margin Performance

A local government's operating margin should always be in surplus (even if it is a small surplus), since a deficit means that the local government is not fiscally sustainable in even the most basic sense. For local governments, the operating margin is the difference between operating revenues (all revenues that are not specifically dedicated to funding capital improvements) and operating expenses (all expenses other than those spent on capital improvements). The operating margin surplus is ultimately a local government's source of funds for repayment of any debt financing or for fulfillment of other financial commitments (e.g., to PPPs) needed to develop infrastructure. Without an operating margin surplus, a local government's infrastructure development is entirely dependent on external development grants or revenue sources that are specified by higher authorities solely for use in infrastructure development.

Assessing Melaka State's Operating Margin

Over the four-year period 2012–2015, Melaka State's operating margin has varied substantially—by one measure between RM 80.7 million and RM 6.9 million. Depending on whether “trust receipts” (a category of revenue reported but not clearly defined in the state's financial statements) are considered operating revenue or revenue for capital improvements, the operating margin may have actually shifted into deficit in fiscal years 2014 (negative RM 53.5 million) and 2015 (negative RM 61 million).⁶ The fundamental problem is that operating revenues are decreasing while operating expenditures are increasing. Depending on whether trust receipts are included, operating revenues decreased by either 23.6 percent (not including trust fund receipts as operating revenue) or 13 percent between 2012 and 2015, but operating expenditures increased by 8.9 percent over the same period. This is not a sustainable pattern for the long run.

Given these trends, Melaka State's operating margin does not provide a substantial foundation on which to finance infrastructure improvements such as improved public transportation. Melaka State has a formally approved capital investment plan, but according to state officials its implementation entirely depends on grants allocated to the state by the federal government, or small increments of annual funding from the state's own budget. Furthermore, the state's capital investment plan does not assess the impact of its projects on the state's operating budget in the future, and therefore may actually contribute to the continuing decline in the state's operating margin.

For Melaka State to undertake any substantial increase in infrastructure financing, specifically for major projects, such as port development indicated in the State Structure Plan 2035 (State of Melaka 2018), it should achieve a reliable surplus in its operating margin. This will require a combination of increasing recurrent own-source revenues (as mentioned previously) and slowing the growth in operating expenditures as much as possible. Fiscal sustainability will depend on the state's ability to increase operating revenues at a pace that exceeds the rate of growth in operating expenditures. The greater the amount of and increasing trend in operating surplus, the better able Melaka State will be to demonstrate fiscal sustainability and ultimately its creditworthiness.

⁶ The operating margin remains positive, although volatile, if it is calculated on the basis that trust receipts are actually operating revenues. However, if trust receipts are treated as funding dedicated to capital improvements, then the operating margin declines steadily from 2012 through 2015 and is in deficit in 2014 and 2015.

Assessing Melaka City's Operating Margin

Melaka City has seen a steady decline in the operating margin, from a surplus of RM 6.6 million in 2012 to a deficit of RM 9.5 million in 2015. Despite overall operating revenue growth of 4.7 percent (including non-recurrent revenues) over the four fiscal years reviewed, operating expenditures increased 17.7 percent over the same period, leading to a decline in margins. Of the city's four largest categories of expenditure (personnel, supplies and services, equipment, and other), only the smallest of the categories (equipment) decreased; the other three increased at rates substantially greater than the rate of operating revenue increase. While it may be that the city's current operating margin trend is somewhat distorted by recent increases in "provisions" for uncollectable amounts due to the city, expenditures on personnel and supplies and services are increasing far faster than are operating revenues. As in the case of Melaka State, this is not a sustainable pattern in the long run.

If the current trends in operating revenues and expenditures persist, Melaka City will be unable to independently finance infrastructure development and will be entirely reliant on state and federal government project grants. Melaka City faces the additional problem that it lacks its own multiyear approved capital investment plan. As a result, its development expenditures are essentially defined by Melaka State rather than a local process of decision making.

As in the case of the state, Melaka City is advised to return to maintaining an operating margin surplus. This will have to be done by increasing the growth in its operating revenue (without resorting to the use of non-recurrent revenue from the sale of assets) to a rate that exceeds the growth in operating expenditures. To the extent that operating expenditure growth can be restrained in the future, the city will find it easier to return to an operating margin surplus. While working on improving its operating margin, the city should also work closely with Melaka State to prepare its own multiyear capital investment plan, including a financing plan that identifies both government and market-based sources of capital for its projects. Only by achieving a reliable operating margin surplus will Melaka City be able to become fiscally sustainable and creditworthy enough to finance any of its own infrastructure requirements.

Building Fiscal Sustainability: Enhance the Handling of Debt and Other Obligations

Long-term financing from loans, bonds, or *sukuk*⁷ is generally the least complex form of financing for a city to use to develop urban infrastructure. In Malaysia, it may be possible to obtain debt financing for durations that approximate the useful life of the infrastructure being financed (once all legal and regulatory constraints are dealt with). In some cases, a PPP may be a good way to finance certain types of city infrastructure that can generate a profit for the private sector partner. In either case regarding debt and PPP financing, potential providers of market-based infrastructure financing need to be convinced that the city can manage its debts and other financial obligations to investors before they provide finance. A fiscally sustainable city will have a track record of successfully managing its debts and other financial obligations, along with well-established policies and procedures governing debt management.

How Melaka State Handles Its Debt and Other Financial Obligations

Melaka State has experience managing long-term and short-term debt. Unfortunately, state finance officials report that their experience in the past has not been entirely free of problems. For example, the state has had to reschedule some of its long-term debt owed to the federal government. They also report that they have on occasion extended the repayment of short-term debt beyond the end of the fiscal year in which it was borrowed. On the positive side, Melaka State officials confirm that the state has policies in place governing the allowable uses of debt financing, the limits on indebtedness, and prioritization of debt repayment over other obligations.

⁷ Although a *sukuk* is not technically a debt-financing instrument, it is structured and performs much like a bond.

Its operating procedures for managing debt in accordance with its policies are said to be informal, rather than written, as are the safeguards it has established to avoid missing payments when they are due.

Melaka State has been conservative in its use of debt financing. It appears that from 2012 to 2015, long-term debt decreased 2.5 percent, from RM 875 million to RM 852.8 million; short-term debt was borrowed and fully repaid within the fiscal year in 2012 and 2013, while no short-term debt was incurred in 2014 or 2015. Melaka State has a unit within the Finance Department that is responsible for debt management. The unit appears to be doing a good job of controlling the debt. However, the state's ability to demonstrate good debt management would benefit from several additional efforts by the debt management unit:

- Establishing written policies on 1) the avoidance of foreign exchange risk in debt financing; 2) the rapid retirement of debt; and 3) the evaluation of financing or refinancing options
- Establishing written procedures that mandate 1) the formal setting aside of funds for debt repayment in advance of payment due dates; 2) the formal review and approval of the use of both long-term and short-term debt financing; 3) the process for enforcing debt limits; 4) the acceleration of debt repayment whenever possible; and 5) the specific steps involved in reviewing and approving specific financing or refinancing transactions
- Making use of specific safeguards against late or missed payments, such as debt service reserve funds, escrowed sinking funds, and revenue intercepts and irrevocable trusts.

Instituting the measures mentioned above would be viewed as positive factors by credit rating agencies and the financial community, and would help Melaka State to achieve a higher credit rating as well as more affordable access to market-based capital.

How Melaka City Manages Its Debt and Other Financial Obligations

Like Melaka State, Melaka City also has experience in managing long-term and short-term debt. It has been relatively conservative in its use of long-term debt. Between 2012 and 2015, long-term debt outstanding appears to have fluctuated between RM 24 million and RM 35.2 million, with RM 25.4 million outstanding at the end of 2015. Compared to the state, the city makes greater use of short-term debt, which ranged between RM 2.7 million and RM 4.2 million over the four fiscal years reviewed.

It is not apparent whether Melaka City has a specific unit within the Finance Department responsible for debt management, nor does it appear that it currently has written policies and procedures governing debt management. The city's ability to demonstrate good debt management would therefore benefit from several additional efforts:

- Assigning specific Finance Department staff the responsibility for debt management
- Establishing written policies on 1) prioritizing of debt repayment over other payments; 2) allowable uses of long-term and short-term debt; 3) limits on indebtedness or debt service expenditures; 4) avoidance of foreign exchange risk in debt financing; 5) rapid retirement of debt; and 6) evaluation of financing or refinancing options
- Establishing written procedures that mandate 1) the formal setting aside of funds for debt repayment in advance of payment due dates; 2) the formal review and approval of the use of both long-term and short-term debt financing; 3) the process for enforcing debt limits; 4) the acceleration of debt repayment whenever possible; and 5) the specific steps involved in reviewing and approving specific financing or refinancing transactions
- Making use of specific safeguards against late or missed payments, such as debt service reserve funds, escrowed sinking funds, and revenue intercepts and irrevocable trusts.

As in the case of Melaka State, instituting the measures mentioned above at city level would be viewed as positive factors by credit rating agencies and the financial community. They would help the city achieve a higher credit rating and more affordable access to market-based capital, and would enhance its role as a partner to the state in Melaka’s sustainable development. For instance, access to Malaysian capital markets (once all legal and regulatory constraints are dealt with) would allow the city to more quickly mobilize funds needed to improve the drainage system and decrease the incidence of flooding in the UNESCO heritage area (as mentioned in *Supporting Report 4: Shaping a Compact, Efficient, and Harmonious Urban Form*).

Recommended Actions

Government revenue flows and intergovernmental transfers are likely to be insufficient to directly fund the whole range of infrastructure identified in the Melaka State and Melaka City urban sustainability plans. So while these local governments should continue to improve their fiscal positions, they should also seek the ability to use their relatively scarce budget resources to leverage market-based financing and thus supplement federal government grants and loans. If adequate sustainable infrastructure is to be developed at a pace that is consistent with Melaka State’s rapid growth, current legal and regulatory restrictions on the use of long-term debt or PPPs must be overcome, and participation of Malaysian sources of finance, including capital markets, must be catalyzed.

To address this challenge, Melaka State, Melaka City, and their urban service providers need to take actions that promote and demonstrate their long-term fiscal sustainability. Melaka State and Melaka City must be able to pay for the delivery of adequate ongoing administrative and urban services while also investing in sufficient infrastructure maintenance and improvements to sustain foreseeable growth in demand for services. Only by demonstrating their fiscal sustainability and creditworthiness can they make a credible case for reforming laws and regulations currently limiting their access to Malaysian market-based financing, and in turn attract Ringgit financing from institutional and private investors for infrastructure projects. The following are key recommendations for Melaka State and Melaka City. A suggested action plan is included in table 1.

For Melaka State:

6-A Obtain a credit rating. This should be done on the Malaysian national scale to demonstrate the state’s degree of fiscal sustainability and creditworthiness. Obtaining the rating would provide the state with a rating report that would be a very useful guide to financial management improvement efforts. Working with a recognized rating agency, the state can start by requesting a private or “shadow” credit rating that would be kept confidential within the state government. Based on the analysis accompanying the shadow rating, the state could identify and implement financial management improvements. These would improve the subsequent public credit rating used to negotiate affordable market-based infrastructure financing (whether debt or PPP).

6-B Improve debt management. Melaka State is advised to do this by

- Establishing written policies on 1) avoidance of foreign exchange risk in debt financing; 2) rapid retirement of debt; and 3) evaluation of financing or refinancing options
- Establishing written procedures that mandate 1) the formal setting aside of funds for debt repayment in advance of payment due dates; 2) the formal review and approval of the use of both long-term and short-term debt financing; 3) the process for enforcing debt limits; 4) the acceleration of debt repayment whenever possible; and 5) the specific steps involved in reviewing and approving specific financing or refinancing transactions

- Making use of specific safeguards against late or missed payments, such as debt service reserve funds, escrowed sinking funds, and revenue intercepts and irrevocable trusts

6-C Undertake a concerted effort to increase the state's own-source revenue. Melaka State is advised to do this by determining

- If its revenue billing and collection efforts are performing to the best possible standard
- If it is possible to increase land valuations or land tax rates
- If the revenue from the sale of goods and services can be augmented
- Whether receipts from state agencies could be increased
- Whether there are any potential new revenue sources (taxes, fees, user charges, etc.) that could be introduced

6-D Achieve a reliable surplus operating margin. This requires a combination of increasing own-source recurrent revenues and slowing the growth in operating expenditures as much as possible. Fiscal sustainability will depend on the state's ability to increase operating revenues at a pace that exceeds the rate of growth in operating expenditures. The greater the amount of and increasing trend in operating surplus, the better able Melaka State will be to demonstrate fiscal sustainability and ultimately its creditworthiness.

For Melaka City:

6-E Obtain a credit rating. Like Melaka State, Melaka City is advised to start with a shadow rating. This should be on the Malaysian national scale to demonstrate the city's degree of fiscal sustainability and creditworthiness. Obtaining a shadow rating would provide the city with a rating report that would be a very useful guide to financial management improvement efforts. These improvements would subsequently help to demonstrate the city's creditworthiness through its public credit rating.

6-F Improve debt management. Melaka City is advised to achieve this by

- Assigning specific Finance Department staff the responsibility for debt management
- Establishing written policies on 1) prioritizing of debt repayment over other payments; 2) allowable uses of long-term and short-term debt; 3) limits on indebtedness or debt service expenditures; 4) avoidance of foreign exchange risk in debt financing; 5) rapid retirement of debt; and 6) evaluation of financing or refinancing options
- Establishing written procedures that mandate 1) the formal setting aside of funds for debt repayment in advance of payment due dates; 2) the formal review and approval of the use of both long-term and short-term debt financing; 3) the process for enforcing debt limits; 4) the acceleration of debt repayment whenever possible; and 5) the specific steps involved in reviewing and approving specific financing or refinancing transactions
- Making use of specific safeguards against late or missed payments, such as debt service reserve funds, escrowed sinking funds, and revenue intercepts and irrevocable trusts.

6-G Work closely with Melaka State to prepare the city's own multiyear capital investment plan. This should include a financing plan that identifies market-based and governmental sources of capital for city projects. A capital investment plan would not only help the city improve its credit rating, it would also enable the city to better prioritize its own projects as a partner to the state in Melaka's development.

6-H Substantially increase recurrent own-source revenues and reduce reliance on non-recurrent revenues. Negotiate with Melaka State on

- Ways to make the city property tax more responsive to changes in property values through more frequent revaluation
- Ways to reduce the city’s heavy dependence on the property tax by introducing additional robust forms of own-source revenue based on the volume of tourism or surcharges on existing service fees and tariffs

6-I Return to maintaining an operating margin surplus. This will have to be done by increasing the growth in the city’s operating revenue (without resorting to the use of non-recurrent revenue from the sale of assets) to a rate that exceeds the growth in operating expenditures. To the extent that operating expenditure growth can be restrained in the future, the city will find it easier to return to an operating margin surplus.

Table 1 Recommended Action Plan for Melaka’s Municipal Sustainability

Item	0–4 Years	5–9 Years	10 or more Years
6-A State: Obtain a credit rating Lead agency: • Finance Department Supporting agencies: • Economic Planning Department	1 year		
6-B State: Improve debt management Lead agency: • Finance Department	1 year		
6-C State: Undertake a concerted effort to increase the state’s own-source revenue Lead agency: • Finance Department Supporting agencies: • Chief Minister’s Office		3 years	
6-D State: Achieve a reliable surplus operating margin Lead agency: • Finance Department		3 years	
6-E City: Obtain a credit rating Lead agency: • Finance Department	1 year		

<p>6-F City: Improve debt management</p> <p>Lead agency:</p> <ul style="list-style-type: none"> • Finance Department 	<p>1 year</p>		
<p>6-G City: Work closely with Melaka State to prepare the city's own multiyear capital investment plan</p> <p>Lead agency:</p> <ul style="list-style-type: none"> • Economic Planning Department <p>Supporting agencies:</p> <ul style="list-style-type: none"> • Finance Department 		<p>2 years</p>	
<p>6-H City: Substantially increase recurrent own-source revenues and reduce reliance on non-recurrent revenue</p> <p>Lead agency:</p> <ul style="list-style-type: none"> • Finance Department <p>Supporting agencies:</p> <ul style="list-style-type: none"> • Mayor's Office 		<p>3 years</p>	
<p>6-I City: Return to maintaining an operating margin surplus</p> <p>Lead agency:</p> <ul style="list-style-type: none"> • Finance Department 		<p>3 years</p>	

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Annex A: List of Indicators Analyzed

Table 2 Indicators Legend

Status	Description
Adequate	The current data is adequate to measure and monitor the dynamic observed.
Outdated	The current data and statistics date from five years ago or longer and need to be updated.
Missing	Statistics are currently unavailable.
Problem Area	Item which requires attention.

Table 3 Summary of the Urban Sustainability Framework's Fiscal Sustainability Indicators for Melaka State

6.1 Accountability and Transparency	Status
Existence of electronic systems for tracking the municipality's management (yes/no)	Missing
Percentage of municipal government accounts audited	Adequate
6.2 Creditworthiness	Status
A credit rating or shadow credit rating on the national credit rating scale of the country	Missing
6.3 Revenue and Financial Autonomy	Status
Own-source revenue as a percentage of total revenue	Adequate
Utility cost recovery (percentage)	Missing
Taxes collected as a percentage of taxes billed	Missing
6.4 Expenditure Management	Status
Operating margin (operating revenues from all sources minus operating expenditures in all categories)	Problem Area
Performance indicators and goals for tracking budget execution	Missing
6.5 Debt and Other Obligations	Status
Debt service ratios (percentage)	Adequate
Ratio of foreign currency debt to local currency debt	Adequate
Debt growth (percentage)	Adequate
Total contingent liabilities that the city could be required to pay in the next five years as a percentage of the city's own revenue in the same period	Missing

Table 4 Summary of the Urban Sustainability Framework’s Fiscal Sustainability Indicators for Melaka City

6.1 Accountability and Transparency	Status
Existence of electronic systems for tracking the municipality’s management (yes/no)	Missing
Percentage of municipal government accounts audited	Adequate
6.2 Creditworthiness	Status
A credit rating or shadow credit rating on the national credit rating scale of the country	Missing
6.3 Revenue and Financial Autonomy	Status
Own-source revenue as a percentage of total revenue	Adequate
Utility cost recovery (percentage)	Missing
Taxes collected as a percentage of taxes billed	Adequate
6.4 Expenditure Management	Status
Operating margin (operating revenues from all sources minus operating expenditures in all categories)	Problem Area
Performance indicators and goals for tracking budget execution	Missing
6.5 Debt and Other Obligations	Status
Debt service ratios (percentage)	Adequate
Ratio of foreign currency debt to local currency debt	Adequate
Debt growth (percentage)	Adequate
Total contingent liabilities that the city could be required to pay in the next five years as a percentage of the city’s own revenue in the same period	Missing

Note: For the Urban Sustainability Framework, see GPSC, World Bank (2018).

Annex B: Additional SWOT Information

Strengths:

1. **State: Fiscal framework is sound; revenue sources exhibit flexibility and resilience.**
It does not appear that the state has resorted to the sale of assets to increase its revenues, and own-source revenues are derived from three principal sources: the land tax; the sale of goods and services; and receipts from Melaka State government agencies. This suggests that there is some degree of flexibility and resilience in the state's underlying revenue structure.
2. **State: Debt management policies are adequate.**
Melaka State has policies in place governing the allowable uses of debt financing, the limits on indebtedness, and prioritization of debt repayment over other obligations.
3. **City: Own-source revenue performance is good.**
Melaka City derives over 80 percent of its total revenue from own-source revenues. The city has also maintained an overall steady level of revenue generation (even a small 1.8 percent increase). This has been possible due to a 6.8 percent increase in the city's own-source revenue between 2012 and 2015, despite a 28.9 percent decrease in intergovernmental transfers over the same four-year period.

Weaknesses:

1. **State: Operating revenues are decreasing while operating expenditures are increasing.**
Depending on whether trust receipts are included, operating revenues decreased by either 23.6 percent (not including trust fund receipts as operating revenue) or 13 percent between 2012 and 2015, but operating expenditures increased by 8.9 percent over the same period. This is not a sustainable pattern for the long run.
2. **State: Long-term debt has been rescheduled in the past.**
Melaka State has had to reschedule some of its long-term debt owed to the federal government.
3. **City: Operating revenues are decreasing while operating expenditures are increasing.**
Despite overall operating revenue growth of 4.7 percent (including non-recurrent revenues) over the four fiscal years reviewed, operating expenditures increased 17.7 percent over the same period, leading to a decline in margins. Of Melaka City's four largest categories of expenditure (personnel, supplies and services, equipment, and other), all but equipment increased at rates substantially greater than the rate of operating revenue increase.
4. **City: Reliance on sale of assets for own-source revenue generation is too great.**
The sustainability of the city's own-source revenue generation is seriously compromised by its ongoing reliance on non-recurrent revenues from the sale of assets. Since the city's saleable assets are by their nature limited, continued reliance on asset sales as a revenue source is not sustainable in the long run.

Opportunities:

1. Domestic sources can provide long-term financing for infrastructure.

In Malaysia, it is possible to obtain financing for durations that approximate the useful life of the infrastructure being financed.

2. Domestic credit rating agencies can provide national scale credit ratings to demonstrate state and city creditworthiness to the domestic financial community.

In Malaysia, national scale credit ratings are available to state and city governments to demonstrate their creditworthiness to the domestic financial community. These ratings can start with a “shadow” or private rating that is seen only by local government officials and that can be used as a guide to improving financial sustainability before a public rating is obtained.

Threats:

1. State: Deteriorating operating margin will prevent financing of infrastructure improvements.

Melaka State’s deteriorating operating margin does not provide a substantial foundation on which to finance infrastructure improvements. The state’s operating margin must remain in surplus in order for the state to take on long-term financial commitments to debt repayment or PPP-related payments. A deteriorating operating margin will render the state uncreditworthy and prevent any market-based financing of infrastructure.

2. City: Deteriorating operating margin will prevent financing of infrastructure improvements.

Melaka City’s deteriorating operating margin does not provide a substantial foundation on which to finance infrastructure improvements. The city’s operating margin, like the state’s, must be in surplus in order for the city to take on long-term financial commitments to debt repayment or PPP-related payments. A deteriorating operating margin will render the city uncreditworthy and prevent any market-based financing of infrastructure.

3. State and city: Grants and loans from federal government and donors may be insufficient to build infrastructure required for sustainability.

Melaka State’s formally approved capital investment plan is entirely dependent on grants allocated to the state by the federal government, or small increments of annual funding from the state’s own budget. If the current trends in operating revenues and expenditures persist, Melaka City will also be unable to independently finance infrastructure development and will be entirely reliant on state and federal government project grants. However, fiscal transfers and funding from international donors may prove too scarce to meet all the investments needed to improve Melaka’s overall sustainability at a pace that matches its rapid growth.

Melaka State in Malaysia has strong sustainability aspirations and is an important member of the Global Platform for Sustainable Cities (GPSC). To inform the next update to Melaka's State Structure Plan, GPSC performed a sustainability outlook diagnostic to holistically consider six dimensions of the state's urban sustainability. The diagnostic consists of an overview report—containing a policy brief, executive summary, and benchmarking assessment—and six supporting reports that cover each of the diagnostic's dimensions. Informed by a wide range of stakeholder consultations and by data, analyses, and the benchmarking assessment, the reports offer key messages and recommendations for action so that Melaka can chart its own pathway to urban sustainability.

