France had a long tradition as a centralized state. However, two waves of decentralization laws—during 1982–83 and 2003–04—contributed to devolving more powers to the three types of subnational governments (SNGs): municipalities, departments, and regions. SNGs in France now have administrative autonomy, own responsibilities, executive powers and, since 2003, financial autonomy. Because there are a large number of small municipalities in France, intermunicipal cooperation arrangements are common, covering a range of services such as water supply, household waste collection, and sewerage. In addition, SNGs may own 50–85 percent of joint public-private partnerships (sociétés d’économie mixte locales, SEMs).

Before 1982, the state controlled all the loans made to SNGs, usually at favorable interest rates. With the 1982 Decentralization Act, SNG access to borrowing was no longer submitted for approval of the Prefect (the representative of the state in each department). The monopoly status of public financial institutions ended in the 1980s, and since then, the credit market for SNGs has consisted mainly of a few banks. Since
Until Debt Do Us Part

the 2008–09 global financial crisis, interest in the development of a subnational bond market has grown.

After some municipalities experienced severe financial distress in the first half of the 1990s, the central government tightened the regulatory framework for SNG borrowing and introduced greater disclosure and transparency. Prudential rules are now used to monitor debt, liquidity, and contingent liabilities. In addition to the borrowing framework, SNGs must also follow accounting and budget rules. Although SNGs have considerable fiscal autonomy, the state exercises strong supervision and monitoring of SNG financial accounts through three institutions: the Prefects, the Regional Chambers of Accounts (Chambres Régionales des Comptes), and Public Accountants.

By law, SNGs cannot declare bankruptcy, and public assets cannot be pledged as collateral. If SNGs become insolvent, the central government intervenes, enforcing fiscal adjustment and facilitating debt negotiations among creditors and the borrower. The central government does not guarantee SNG borrowing but may provide exceptional financial assistance. However, the amount of assistance by the central government is extremely small, and there is no expectation of a state bailout.

SEMs are subject to standard corporate insolvency law. Other government-owned entities, such as établissements publics (public establishments), which are financially autonomous agencies, are as a general rule subject to administrative law. In such cases, liquidation is not an option.

This chapter reviews how the French system combines decentralized responsibilities and fiscal decisions with fiscal monitoring from the central government and how central monitoring, supervision, and intervention deals with SNG insolvency. As part of this volume that reviews and shares country experiences in managing subnational debt and related regulatory reforms, this chapter covers up to 2010.1

The rest of the chapter is organized as follows. Section two reviews SNG institutional structures and finances. Section three focuses on three channels of control and monitoring of SNGs by the central government. Section four presents the subnational borrowing framework and the evolution of subnational credit markets. Section five discusses contingent fiscal risks arising from various forms of intermunicipal and public-private arrangements. Section six explains how the French system resolves SNG insolvency. Section seven offers conclusions.
**Institutional Structures and Finances of Subnational Governments in France**

**Administrative Structure**

French decentralization dates back a thousand years to the emergence of France as an independent state. Municipalities (*communes*) were created relatively recently—in 1789—the year the French Revolution (*Révolution Française*) began. The departments (*départements*) were created the following year, in 1790, before becoming local authorities at the beginning of the Third Republic, owing to the first decentralization law of August 10, 1871. That law reorganized the balance of power within municipalities and provided a check on mayoral authority through town councils. Regions (*régions*) were created in 1972 and were given the status of local authorities in 1982.

Before 1982, departments and municipalities had limited competences. As representatives of the central government in each department, the Prefect held the executive power and in that capacity supervised the laws passed by all SNGs and had the power to approve or cancel subnational decisions. The two waves of decentralization since the early 1980s have led to a major shift in the history of French institutions. The resulting administrative structure is summarized in figure 6.1.

Under Title XII of the French Constitution, SNGs are administrative structures—distinct from the national administration—that exercise competences within a given territory. France consists of 26 regions, 100 departments, and 36,682 municipalities, which account for 40 percent of all European SNGs. There is no hierarchy among the three levels of government, and none may exercise authority over another territorial entity. Four regions and four departments have a special status.

**Two Waves of Decentralization**

In the early 1980s, a national law was passed mandating major reform of French institutions. Reforms included:

- Replacement of ex-ante prefectural control with ex-post legal control exercised by the Prefect, the National Court of Accounts (*Cour des Comptes*), and the newly created Regional Chambers of Accounts (RCA), in charge of budgetary control of SNGs.
• Transfer of executive power at the departmental level to the president of the General Council (that is, the executive power in the department).

The laws of January 7, 1983, and July 22, 1983, determined the respective competences of the central government and SNGs and set up the rules for transferring financial resources. These laws are now regarded as “Act I of French decentralization.”

A second wave of decentralization began in 2003. Constitutional Law No. 2003-276 refers to the “decentralized organization of the Republic” and mentions the regions in the Constitution. The three local government levels (municipalities, departments, and regions) are considered “territorial communities” (collectivités territoriales). SNGs have their own executive powers and, since 2003, the Constitution recognizes their financial autonomy. The Constitution also recognizes various intercommunal structures and allows for the merger of existing SNGs with larger entities. The constitutional reform also enshrines direct democracy at the local level, the financial autonomy of territorial entities, and the governance of overseas territories.

Table 6.1 New Powers Devolved to SNGs in 2004, France

<table>
<thead>
<tr>
<th>Municipalities</th>
<th>Powers before 2004</th>
<th>Additional powers since 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic and territorial development</td>
<td>• Local public utilities (waste collection and treatment, water distribution, sewerage)</td>
<td>• The law of August 13, 2004, did not significantly affect the responsibilities and finances of municipalities.</td>
</tr>
<tr>
<td></td>
<td>• Urban planning</td>
<td></td>
</tr>
<tr>
<td>Social aid and health</td>
<td>• Social aid (childcare and kindergartens)</td>
<td></td>
</tr>
<tr>
<td>Education and culture</td>
<td>• Construction and maintenance of primary schools</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Departments</th>
<th>Powers before 2004</th>
<th>Additional powers since 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic and territorial development</td>
<td>• Construction and maintenance of secondary roads</td>
<td>• Management of some formerly national roads and staff (since 2006)</td>
</tr>
<tr>
<td></td>
<td>• Interurban public transport</td>
<td></td>
</tr>
<tr>
<td>Social aid, solidarity, and health</td>
<td>• Social assistance (children, disabled adults, and elderly)</td>
<td>• Financial assistance for the young</td>
</tr>
<tr>
<td></td>
<td>• Implement the minimum subsistence allowance (since 1988) as set at the national level</td>
<td>• Finance social funds for housing</td>
</tr>
<tr>
<td></td>
<td>• Preventive health care</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Medical prevention</td>
<td></td>
</tr>
<tr>
<td>Education and culture</td>
<td>• Construction and maintenance of public junior high schools</td>
<td>• Management of some nonteaching staff in junior high schools</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Regions</th>
<th>Powers before 2004</th>
<th>Additional powers since 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Education</td>
<td>• High school construction, maintenance, and operating costs</td>
<td>• Establish education requirements</td>
</tr>
<tr>
<td></td>
<td>• Fund professional training</td>
<td>• Fund schools</td>
</tr>
<tr>
<td></td>
<td>• Cofund universities</td>
<td>• Management of nonteaching staff in high schools (since 2006)</td>
</tr>
<tr>
<td>Economic, territorial development, and transport</td>
<td>• Organize and finance regional passenger rail services</td>
<td>• Transfer of private-sector economic aid to regions</td>
</tr>
<tr>
<td></td>
<td>• Responsibility for infrastructure</td>
<td>• Formulate regional plans for economic distribution</td>
</tr>
<tr>
<td></td>
<td>• Allocation of subsidies (business tax exemption)</td>
<td></td>
</tr>
<tr>
<td>Culture</td>
<td>• Organization and financing of regional museums</td>
<td>• Responsibility to compile inventory of cultural patrimony</td>
</tr>
<tr>
<td>Health</td>
<td>n.a.</td>
<td>• Health care education services (prevention actions, vaccination, etc.) Possibility of financing sanitary facilities</td>
</tr>
</tbody>
</table>

Source: Fitch Ratings 2008a.
Note: n.a. = not applicable.
The two waves of decentralization changed not only the structure and responsibilities of SNGs, but also central government oversight and control. Departments and regions received additional responsibilities and resources, mainly through greater tax-raising power, and administrative autonomy (Fitch Ratings 2008a).

**The Importance of Inter-SNG Entities and SNG-Owned Firms**

Compared to other countries, France has a large number of tiny municipalities, with an average population of just over 1,600. More than 20,000 municipalities have fewer than 500 inhabitants, and 32,000 municipalities have less than 2,000 inhabitants. Intermunicipal cooperation began in the late 19th century to overcome fragmented services of small SNGs. Since then, many cooperative legal structures (établissements publics de coopération intercommunale) have often been established across municipal boundaries to carry out responsibilities more efficiently.

There are two major types of intermunicipal cooperation structures: (a) structures without own-source tax revenue, that is, single-purpose structures (syndicats de communes à vocation unique) and multipurpose structures (syndicats de communes à vocation multiple); and (b) large intermunicipal structures that can levy their own taxes (for example, a local business tax).

Three types of municipal cooperation with own-source tax revenue were created in 1999. They are (a) communautés de communes (associations of villages, by small towns), (b) communautés d’agglomérations (associations of towns) for medium-size urban areas of 50,000–500,000 inhabitants with at least one city with a minimum of 15,000 inhabitants), and (c) communautés urbaines (urban communities with at least 500,000 inhabitants).

In 2008, 91 percent of French municipalities, accounting for 87 percent of the population, belonged to at least one of the 2,583 intermunicipal cooperation structures with own-source tax revenue. These structures are funded through taxes they levy and grants from the central government. Intermunicipal cooperation structures have a deliberative body made up of elected counselors from the participating municipalities, an executive, and a committee. The intermunicipal structures delegate a growing share
of the service delivery functions to the three main types of public entities they own or over which they exercise control.

The first type of public entity is SEMs—public-private partnerships—which are commercial companies subject to the corporate insolvency law and commercial laws. The delegation of powers to SEMs often concerns infrastructure service delivery, such as public transport. SNGs must own between 50 and 85 percent of the capital. If an SEM finds itself in financial distress, its “public” assets are typically transferred to a new entity that continues its public service function, a procedure that is sometimes used for privately owned companies. SNGs bear the losses of SEMs as shareholders and may be liable under implicit or explicit guarantees. Although the SNG is the majority shareholder, oversight by subnational deliberative bodies is sometimes weak.

The second type of public entity is public establishments (établissements publics)—financially autonomous agencies subject to administrative law. Public establishments are mainly created in the health, education, and cultural sectors. Despite their relative autonomy, public establishments are controlled by SNGs. As entities governed by public law, they cannot be liquidated. The largest public establishments are supervised by the central government.

The third type of public entity is the nonprofit association, which often receives grants from subnational administrations. Elected officials generally hold key posts in these associations. This kind of collaboration could pose fiscal risks for the local government, since the local government may have to help close the fiscal deficits of associations that are deemed to be essential for social cohesion.

**Structure of Subnational Finances**

In 2009, SNG expenditures in France amounted to €214 billion, which represented 21 percent of total public expenditures. On average, municipalities accounted for about 49 percent of SNG expenditures, departments for 36 percent, and regions for 15 percent. Tax revenues accounted for about 49 percent of SNG total revenues. Financial transfers from the central government to SNGs accounted for about 21 percent for municipalities and departments and 31 percent for regions. Borrowing accounted for less than 10 percent of SNG total revenue (figures 6.2, 6.3, and 6.4).
Figure 6.2 Sources of Municipal Revenues in France

Source: General Directorate of Subnational Entities (Direction Générale des Collectivités Locales, DGCL) 2011.
Note: The latest data from DGCL 2011 are 2009 figures.

Local taxes 31.2%
Nonlocal taxes 14.8%
State transfers 21.0%
Other sources 11.6%
Investment revenues 14.1%
Borrowing 7.3%
Investment revenues 14.1%
Other sources 11.6%
State transfers 21.0%
Borrowing 7.3%

Figure 6.3 Sources of Departmental Revenues in France

Source: DGCL 2011.
Note: The latest data from DGCL 2011 are 2009 figures.

Local taxes 33.1%
Nonlocal taxes 23.0%
State transfers 20.1%
Other sources 9.3%
Investment revenues 6.9%
Borrowing 7.6%
Investment revenues 6.9%
Other sources 9.3%
State transfers 20.1%
Borrowing 7.6%
SNGs have three main kinds of revenues: state transfers (about €72 billion in 2008) (Fitch Ratings 2008a), local taxes, and shared taxes (nonlocal taxes). The four local taxes are as follows:

- The residential tax, based on the rental value of property (taxe d’habitation)
- The building tax (taxe sur le foncier bâti)
- The land tax (taxe sur le foncier non-bâti)
- The business tax paid by owners (companies and individuals) and by companies based on fixed-asset rental value and on payroll (taxe professionnelle) (Rapport Balladur 2009).

The shared taxes are (a) the oil tax (taxe intérieure sur les produits pétroliers), (b) the tax on insurance contracts, (c) the tax on real estate transactions, and (d) the vehicle registration tax. The transfers from the central government are mainly composed of the Dotation Globale de Fonctionnement (General Public Service Grant), which is nonearmarked.
The 2008–09 global financial crisis weakened the financial position of French SNGs. Although the impact has been mitigated by the central government’s stimulus package (Fitch Ratings 2009), the sustainability of SNG fiscal positions, in view of the uncertainty in the global recovery, remains in doubt. In April 2010, the Jamet Report (Rapport Jamet 2010) projected that 11 departments might face financial distress. These departments have faced dramatic increases in social spending and dramatic decreases in revenues.

Control and Monitoring by the Central Government

While there is substantial decentralization in France today, the central government continues to exercise control over SNGs through balanced budget rules for SNGs, and through three key institutions—the Prefect, the RCA, and the Public Accountants—all of which play a large role in policy making at the subnational level. The Prefect is the representative of the central government in the department and exercises general oversight of municipal activities. The RCA is responsible for controlling SNG accounts. The Public Accountants, as public servants in the central government, are responsible for ensuring the regularity of SNG payments.

Balanced Budget Rules and Processes

The state supervises SNGs through balanced budget rules; that is, the budget of an SNG must be balanced. This principle is implemented through the budgetary processes; the assemblies that approve the budgets must vote budgets in which the investment section and the operating (or current) section are each balanced. This equilibrium must be based on reasonable assumptions about the revenue and expenditures (real equilibrium) and must include all the compulsory expenditures including debt service. Compulsory expenditures must be paid from revenues and cannot be paid from borrowed funds. Box 6.1 presents the specific rules regarding the budget processes.

The Prefect and the Regional Chamber of Accounts

The central government also exercises detailed and regular oversight to ensure that SNGs are able to meet their debt obligations.
oversight comes in three forms: legal, budgetary, and management. The focus is on the prevention of subnational financial distress through an elaborate system of controls, including oversight by Public Accountants of all SNG disbursements. These ex-ante controls are designed to substantially reduce the probability of default.

Legal controls concern the legal validity of acts, such as compliance, respect for procedural rules, and mistakes on points of law or fact or abuse of power or procedure. In particular, assembly votes or the imposition of taxes are subject to a review of their legality. The Prefect or any affected person may appeal to the administrative judge, who has power to annul the act in whole or in part.

Budgetary control concerns the budgetary process, as prescribed by law. The deadlines for the regular (as opposed to extraordinary) budgetary process are presented in table 6.2.
The Prefect controls the legality of the local budget ex post (Articles L. 1612-1 to L. 1612-20 of the CGCT). Article 47-2 of the French Constitution states:

The National Court of Accounts assists Parliament in the control of the action of the government. It assists Parliament and the government in the control and execution of finance laws and the social security financing laws as well as in the evaluation of public policies. It helps to inform the electorate by publishing public reports. The public administration accounts must be regular and in good faith, and give an accurate picture of the results of their management, of their property and of their financial situation.

SNG budgetary decisions must be sent to the Prefect. The Prefect, or any other person affected by the decisions (for example, any taxpayer living in the jurisdiction of the SNG or any debtholder) can contest the legality of the decisions before the administrative tribunals within two months of their adoption. An example would be new borrowing to cover a deficit in the operating budget, which is prohibited by the budget legislation. The administrative judge has the power to nullify the decision.

The Prefect and the RCA are in charge of budgetary controls. RCAs were created by the law of March 2, 1982. Each region has its own Chamber, and all members, called magistrates, have life tenure. These courts have jurisdiction not only over SNGs, but also over public establishments (hospitals, public secondary schools, and so forth), public-private partnerships, and associations funded by SNGs. Budget decisions need to be sent to the Prefect when adopted. RCAs have the power to make adjustments to budget proposals (fiscal adjustments).

### Table 6.2 Deadlines for the Regular Budget Process, France

<table>
<thead>
<tr>
<th>Date</th>
<th>Process</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1</td>
<td>Beginning of the financial year</td>
</tr>
<tr>
<td>April 15</td>
<td>Deadline for the adoption of the draft budget</td>
</tr>
<tr>
<td>June 1</td>
<td>The current financial account kept by the public treasury must have been transferred to the local assembly</td>
</tr>
<tr>
<td>June 30</td>
<td>The current administrative account kept by the local government must have been approved by the local assembly</td>
</tr>
<tr>
<td>December 31</td>
<td>End of the financial year</td>
</tr>
</tbody>
</table>

Should these proposed adjustments by the Chamber not be incorporated into the budget, the Prefect may intervene to ensure that SNGs meet their compulsory expenditures and comply with balanced budget rules. The Prefect can choose to disregard the RCA recommendations but must explain the reasons for doing so.

Budgetary control concerns only budgetary instruments in the strict sense: the draft budget, any supplementary budget, decisions to modify the existing budget, any annexed budget, and the administrative account. Control is limited to the following: (a) the dates of the vote and the submission of the initial budget, (b) the balancing of the budget, (c) the approval of the accounts, and (d) the inclusion and payment of compulsory expenditures. If a violation occurs, the Prefect refers the matter to the RCA, which may then modify the budget decision.

The draft budget must be sent to the Prefect within 15 days of passage. Otherwise, the Prefect asks the RCA to intervene. In 2007 and 2008, the Chambers rendered 114 decisions on budgets, 49 of which were for missed budget deadlines (National Court of Accounts 2009c).

Regarding balancing the budget, the Prefect can refer the matter to the RCA up to one month after receiving the budget. The court has one month from that date to propose measures to the concerned SNG to balance the budget. The Chambers made 112 decisions in 2007 and 146 decisions in 2008 concerning unbalanced budgets (National Court of Accounts 2009c).

If the budget deficit exceeds 5 or 10 percent of receipts, depending on SNG size, the Prefect may call on the RCA to intervene. The Prefect is required to refer inaccurate or illegal budget decisions to the RCA within one month. The cases to be referred include, but are not limited to, those in which the operating budget is in deficit, or in which compulsory expenditures such as debt service are not included in the budget.

The RCA issues proposals within two months to ask SNGs to balance their budgets, which may include the SNGs cutting expenditures and raising taxes. The Prefect must send the revised budget for the next fiscal year to the Chamber. If the municipality has not taken sufficient deficit-cutting measures, the RCA proposes other measures to the Prefect within one month. The Prefect may seize fiscal control and impose a budget. Alternatively, the Prefect may reject the proposals made by the
Chamber, but must explain why. There were 119 such RCA interventions in 2006 for these controls.31

Compulsory expenditures must be included in the budget and must be paid. The Prefect, or any other person adversely affected by their exclusion, can initiate proceedings before the competent Chamber. This is the most common reason the RCAs are called on (Bouvier 2008). For instance, debt service, including both principal and interest, constitutes a compulsory expenditure. Debt service must, therefore, be entered as an expenditure item in the annual budget. If debt that is due is unpaid, a lender can ask an administrative tribunal to include the debt service in the SNG’s budget and enforce payment (mandatement d’office) (Articles L. 1612-15 to L. 1612-17 of the CGCT). The Prefect has the right to refuse the RCA recommendations, but must explain the reasons for the decision. If the Prefect accepts the decision of the Chamber, and unless the SNG can defend against such action on the grounds that the sum is not in fact due, the tribunal decides in favor of the lender. The payment order is issued, and the Public Accountant pays the debt.

Funds, of course, need to be available in the SNG account to execute a payment order. This is essential for budget control. The measures may not be successful if the financial distress is discovered late. Herein lies the essential role of RCAs. In the case of Pont-Saint-Esprit, the National Court of Accounts recommended several measures to ensure the enforcement of recovery proceedings, such as the compulsory publication of prefectoral decisions before town council deliberations, and the recognition of personal liability if the measures are not executed (National Court of Accounts 2009a).32

Tax receipts regularly flow into SNG accounts. If the available funds are insufficient for payment, the representative of the central government in the department issues an overdue notice and calls on the entity in question to create the necessary resources for payment. If the assembly of the SNG or the public entity does not create the necessary resources, the representative of the central government in the department or the supervisor takes over and, when necessary, orders payment (mandatement d’office) (figure 6.5).

Oversight of SNG budgets by the central governments requires internal controls of SNGs. Indeed, facing an increase of SNG expenditures over the last 25 years, SNGs have strengthened internal management
control systems not only to ensure the legal validity of their budgetary accounts but also to achieve their goals at lower costs. More recently, a growing number of municipalities have collaborated with respect to their financial control systems through intermunicipal cooperation arrangements, for example, as regards the (costly) training of staff specialists. The Rapport Balladur (2009), the Rapport Mauroy (2000), and the Rapport Richard (2006) encouraged such cooperation.

Management control by the central government refers to the decisions made ex post by the courts, most often in the form of reports.
The role played by courts has increased over time, though some SNG politicians have been critical of their growing role. Indeed, even if the courts only pass on whether the funds have been used for their intended purposes, local councillors often consider this a means of questioning their management and policy priorities, which is why these proceedings are suspended during elections. The law of December 21, 2001, forbids value judgments (see Article L. 211-8 of the *Code des juridictions financières* [Code of Financial Tribunals]).

The Chamber has special powers to enable it to perform its duties (for example, it has access to all necessary documents). At the end of the audit, the Chamber sends an interim report to the controlled local government, which can reply or request a hearing. The Chamber analyzes the audit and publishes a final report. The local government can respond a second time. Its replies will be published with the report and will be accessible to the public.

**The Public Accountants**

France distinguishes between the expenditure function and the treasury function. *Ordonnateurs* (ministers, mayors, and presidents of local councils), who order expenditures, are separate from *comptables* (Public Accountants), who make payments and manage the funds. All Public Accountants are central government civil servants. They are appointed by the Finance Minister to perform treasury and accounting functions. They record SNG receipts and order payment of SNG expenditures on behalf of SNGs. Public Accountants ensure compliance with budgetary rules; they do not decide budgetary priorities. The decision by a Public Accountant not to pay an expenditure item may be overridden by the *ordonnateur* pursuant to an *ordre de requisition*, to make the payment out of the SNG funds. However, the *ordonnateur* is liable with his personal assets if the expenditure violates the budgetary rules.

As regards receipts, the control by Public Accountant is more limited. Tax revenues are controlled by the fiscal administration, and Public Accountants simply record and verify receipts.

With respect to expenses, Public Accountants are personally responsible for failing to perform their duties. They are potentially liable for all financial transactions. They verify the budgetary allocation, expenditure items, debt and its servicing, revenue receipts, the
availability of funds, and the clauses of the financial transactions. In the event of noncompliance with these requirements, Public Accountants are obliged to suspend the financial transaction.

Public Accountants, who exercise ongoing controls over SNG finances, are themselves subject to two types of control: administrative and jurisdictional. With respect to administrative control, Public Accountants are supervised by the *Tresorier-Payeur General* (State Treasurer), the highest-ranking public accountant. Internal audit within the Ministry of Finance is performed by an internal audit unit—the *Mission d’audit, d’évaluation et de contrôle* (Audit, Evaluation and Control Group)—and the *Inspection Generale Des Finances* (General Inspection of Finance)—a group of top civil servants acting as a senior auditor and advisory service for the Ministry of Finance. This is to ensure that Public Accountants comply with laws and regulations and carry out antifraud enforcement. Members of the General Inspection of Finance have special powers (access to all necessary documents, particularly to the records of all Public Accountants, and the right to suspend accountants temporarily in cases of fraud).

With respect to jurisdictional control, though not in charge of administrative control of Public Accountants, the RCA can issue judgments against a Public Accountant, as a follow-up of the compliance audits they perform on local authorities. If a Public Accountant fails to perform his or her duties, he or she is legally liable and must pay with his or her own personal funds, if necessary. If the accounts are judged as regular, Public Accountants are exonerated from liability.

France has a unique system for managing SNG cash. All state and SNG funds are centralized daily in a single state treasury account. Public accountants accept all receipts and authorize all expenditures that are in compliance with budgetary rules. The general rule is that SNGs must deposit all cash with the State Treasurer. For payments, the SNG requests the Treasurer to pay the debtor, the so-called payment order (*mandatement*). Revenues, transfers from the central government, and subnational tax receipts—subnational taxes are set by the SNG but are collected by the state’s tax collection agents—are also transferred to the SNG’s noninterest-bearing cash account held by the Treasurer. In return, the Treasury does not charge SNGs for managing their cash and can advance money against future tax revenues when SNGs do not have sufficient cash.
New procedures have been developed since 2006 to facilitate the control exercised by Public Accountants. These controls operate at several levels. New instruments, such as the computer system Helios, ensure that the control of recurrent expenditures is systematized and separated from the control of unusual expenditures. In the same way, the system of Contrôle hiérarchisé de la dépense (Multi-layered Control of Expenditures) establishes a set of controls. This system helps Public Accountants redefine their priorities.

Subnational Debt

Subnational Borrowing Framework

Before the decentralization laws of 1982, the Prefect exercised ex-ante control (contrôle a priori), preventing a municipality, department, or region from borrowing if the loan was determined to be unfavorable to the interest of the SNG (that is, if the loan would result in overborrowing). Moreover, only two state-owned financial institutions could lend money to subnationals. In 1982, SNGs became responsible for their own borrowing and could decide whether and how much to borrow without ex-ante control. In 1986, the central government stopped offering loans with privileged interest rates to SNGs. The same year, the requirement to borrow from government lenders was abolished. Currently, SNGs mainly rely on bank loans, and compared to the subnational bond market in the United States, the French subnational bond market is tiny: more than 20,000 U.S. SNGs and federal and local government-owned enterprises are rated compared to about 40 in France.

In the early 1990s, some municipalities in France experienced severe financial distress. In the second half of the 1990s, the central government tightened the regulatory framework for SNG borrowing, introduced greater disclosure and transparency requirements, and implemented an early warning system.

Key elements of prudential rules regulating debt, liquidity, and contingent liabilities include the following:

- New long-term borrowing must fund capital investments only.
- Debt payments are compulsory expenditures and must be fully budgeted.
• Annual debt service, including that paid on guaranteed loans, must be less than 50 percent of operating revenue.\textsuperscript{38}

• No single borrower may benefit from a guarantee exceeding 5 percent of the SNG’s operating revenue.\textsuperscript{39}

• Guarantees may not exceed 50 percent of the principal.

SNGs are required to deposit cash with the central government, which carries out all payments following the control framework discussed in the previous section. In addition to the borrowing framework, SNGs must also follow certain accounting and budget rules. These rules include balanced budget rules requiring that both operating and capital accounts be balanced and annual debt service be covered by SNG own revenues.

Subnational borrowing can take the form of a loan, a bond issue, or other instruments including structured products. There must be a positive balance in the operating budget so that it can cover principal payments.\textsuperscript{40} Article L. 2122-22 of the CGCT states:

The mayor may, in addition, on delegated powers of the city council, be authorized, in whole or in part, and for the duration of his mandate:

To borrow, within the limit set by the city council, for the purpose of financing investments as foreseen in the budget, and for financial operations that are useful for managing its lending, including hedging for interest and exchange rate risk.

According to articles L. 200-3, L. 335, and L. 4333-1 of the CGCT, municipalities, regions, and departments may borrow. According to Article L. 2331-8 of the CGCT, the proceeds from borrowing constitute nonfiscal income in the investment section of the SNG budget. Borrowing is defined as the aggregate of all debts contracted with a maturity exceeding one year during the legislative period and allowed for capital investment only. Short-term borrowing with a maturity shorter than one year is treated differently.\textsuperscript{41} This short-term debt finances the liquidity of SNGs and is allowed for all types of expenditures.

Subnational borrowing is not subject to the compulsory submission of bids from several lenders,\textsuperscript{42} although SNGs are required to hold a tender for other banking and investment services if they exceed a certain threshold.\textsuperscript{43}
Nevertheless, even if SNGs became responsible for their own borrowing, their freedom of management is still limited by the control of RCAs, which can declare certain SNG acts void. This control does not contravene the progressive autonomy granted to SNGs, but is in accordance with the law. Thus, subnational borrowing must conform to several rules, such as the prohibition against financing day-to-day management by resorting to borrowing, the prohibition on speculation, and the requirement of publishing borrowing activities as part of budget documents. In this respect, contracts must fulfill the conditions defined by the Conseil national de la comptabilité (National Council of the Comptroller) in its ruling of July 10, 1987, to be considered as financial risk management instruments. The publication of information on borrowing activities attached to budgetary documents is necessary to inform local councillors and citizens about the financial commitments of the subnational entity (with a list of the establishments the entity has contracted with) (Robert 2009).

Evolution of Subnational Debt in France

Following passage of the 1982 decentralization laws, the subnational debt-to-expenditure ratio increased. SNG debt accounted for 11.1 percent of GDP in 2007, up from 8.5 percent in 1982 (Rapport Pébereau 2005). This increased borrowing financed new social, economic, and infrastructure programs resulting from the devolution of new responsibilities to SNGs.

In 2009, municipal borrowing reached €6.75 billion compared to €5.1 billion for departments and €3.6 billion for regions. Until 2002, the three levels of SNGs managed to have positive net repayments (meaning that their debt repayment was higher than their borrowing). Since then, the trend has reversed. There has been a significant increase in the borrowing of regions, departments, and municipalities—up 153, 64, and 10 percent, respectively, between 2003 and 2009 (figure 6.6).

This trend is partially due to the Law on Local Rights and Responsibilities (Law 2004-809), which deepened the devolution process. New responsibilities were transferred to SNGs during 2005–07, particularly to regions and departments. For instance, regions are responsible for social and health care and education services, economic development, vocational training, and grants to private high schools. Departments are responsible for assistance for the young, social funds for housing, grants provided to disabled people, management of some nonteaching staff in
junior high schools, management of some formerly national roads, and grants to private junior high schools (Fitch Ratings 2008a).

The Lenders
Until 1987, the Crédit Local de France had a monopoly on municipal lending. Since then, the French subnational credit market has been, in essence, an oligopoly composed of four banks—Dexia (by far the largest bank in this market), Caisse d’Epargne, Crédit Agricole, and Société Générale—which together control 80 percent of the market. Dexia, in particular, played a leading role in the aggressive selling of structured products, and received heavy blame following the global financial crisis. With the crisis, Dexia entered a period of turbulence and survived due to central government support. The bank shed a number of its subsidiaries abroad. The support by the government created particular controversy in light of widespread allegations that Dexia aggressively overloaned to SNGs, both in volume and in terms of risky products.

From 2000 onward, few foreign banks have made loans to SNGs. The Swiss bank UBS tried unsuccessfully to enter the market in the early 2000s. In contrast, the Royal Bank of Scotland managed to lend

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Figure 6.6 SNG Borrowing and Debt Repayment in France

Source: DGCL 2011.
to some SNGs, such as the city of Aubagne. Most SNGs get financing through bank loans. There are exceptions, such as the City of Paris: in 2008, €331 million was raised, €251 million of which was in the form of bonds and only €80 million of which was in the form of bank loans (Mairie de Paris 2009). Since the early 2000s, SNGs have had the opportunity to borrow through the following channels: bank loans (fixed-interest loans, variable-interest loans, structured loans, and revolving loans denominated in euros or in foreign currency), or bond issues (short-term commercial paper, medium- or long-term securities, and derivative bonds).

**Creditworthiness of SNGs**

SNGs willing to issue bonds need a rating. As of December 26, 2011, Moody’s, Fitch, and Standard & Poor’s (S&P) rated 3, 9, and 13 SNGs, respectively. Unlike sovereign and corporate borrowers, most SNGs are rated by a single agency. All rated SNGs are in the investment grade category with the exception of the Overseas Territory of French Polynesia, which was rated BB+ by S&P. Eighty-eight percent of SNGs are rated AAA/Aaa or AA/Aa, which reveals strong creditworthiness overall (figure 6.7).

**Figure 6.7 Distribution of Ratings Assigned to French SNGs**

Source: Authors’ computations from Fitch, Moody’s, and S&P.

Note: SNG = subnational government. Ratings are Fitch, Moody’s, and Standard & Poor’s as of December 26, 2011. There are 25 SNG ratings.
Managing Subnational Contingent Fiscal Risks

There are two types of SNG contingent fiscal risks.

The first fiscal risk comes from potential liabilities of companies owned by SNGs. In addition, SNGs sometimes guarantee liabilities of other entities. Rating agencies typically count the debt incurred by such companies as the indirect debt of the local government that owns the SEM. In Fitch’s ratings of the nine French SNGs in December 2011, the net indirect debt plus guarantees range from 0.1 to 74.7 percent of net overall debt, with an average of 31.1 percent (table 6.3). Regulations on SNG companies have been tightened, including the compulsory publication of guarantees, ownership, and subsidies. No single borrower may benefit from a guarantee exceeding 5 percent of operating revenue, and guarantees may not exceed 50 percent of the principal. Table 3 provides a snapshot of the scope of indirect debt of selected French SNGs.

Table 6.3 Debt Data for French SNGs Rated by Fitch

<table>
<thead>
<tr>
<th>Fitch data</th>
<th>Net direct debt (million euros)</th>
<th>Net guaranteed + indirect debt (million euros)</th>
<th>Net overall debt (million euros)</th>
<th>Net guaranteed + indirect debt/net overall debt (%)</th>
<th>Year</th>
<th>Rating (as of December 26, 2011)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Essonne (department)</td>
<td>780.3</td>
<td>220.9</td>
<td>1,001.2</td>
<td>22.1</td>
<td>2009</td>
<td>AA</td>
</tr>
<tr>
<td>Guadeloupe (department)</td>
<td>110.6</td>
<td>215.8</td>
<td>326.4</td>
<td>66.1</td>
<td>2010</td>
<td>AA–</td>
</tr>
<tr>
<td>Île-de-France (region)</td>
<td>3,506.8</td>
<td>11.3</td>
<td>3,518.1</td>
<td>0.3</td>
<td>2010</td>
<td>AAA</td>
</tr>
<tr>
<td>Paris (city)</td>
<td>2,695.0</td>
<td>7,957.0</td>
<td>1,0652.0</td>
<td>74.7</td>
<td>2010</td>
<td>AAA</td>
</tr>
<tr>
<td>Picardie (region)</td>
<td>471.5</td>
<td>0.4</td>
<td>471.9</td>
<td>0.1</td>
<td>2009</td>
<td>AA–</td>
</tr>
<tr>
<td>Provence-Alpes-Côte d’Azur (region)</td>
<td>1,664.1</td>
<td>150.0</td>
<td>1,814.1</td>
<td>8.3</td>
<td>2010</td>
<td>AA</td>
</tr>
<tr>
<td>Rhône-Alpes (region)</td>
<td>1,357.2</td>
<td>48.2</td>
<td>1,405.4</td>
<td>3.4</td>
<td>2009</td>
<td>AAA</td>
</tr>
<tr>
<td>Seine-et-Marne (department)</td>
<td>892.2</td>
<td>585.3</td>
<td>1,477.5</td>
<td>39.6</td>
<td>2010</td>
<td>AA</td>
</tr>
<tr>
<td>Strasbourg (city)</td>
<td>151.9</td>
<td>285.1</td>
<td>437.0</td>
<td>65.2</td>
<td>2010</td>
<td>AA+</td>
</tr>
</tbody>
</table>

Note: SNG = subnational government.
The second fiscal risk results from the strong growth of complex structured products since the 1990s. Structured products with increasingly risky instruments combine various derivative instruments with a loan structure. At end-2007, the volume of structured products was €30 billion to €35 billion in total borrowings of €137.5 billion (Fitch Ratings 2008a).

The first step toward structured products took place in the 1990s, when SNGs tried to renegotiate their debts with fixed interest rates (Paris 2009). Since interest rates were higher in the 1980s and declined sharply in the 1990s, such renegotiation enabled the SNGs to reduce their debt. Banks even offered such products to small SNGs. The National Court of Accounts had already published a report, in 1991, about debt management, focusing on the increasing importance of structured products in SNG debt.

Four types of structured products were used: (a) borrowing with variable interest rates (with options to minimize risk), (b) products with barriers (the interest rate is guaranteed until an index reaches a threshold), (c) snowballing products (discussed below), and (d) products indexed on an exchange rate or a difference in inflation levels.

For products with barriers, the interest rate is fixed until a threshold is crossed. For most of the 2000s, the threshold was not reached. When the global financial crisis hit, interests rates often came close to the threshold. Once the threshold is crossed, the interest rate increases quickly.

Snowballing products are those for which the interest rate depends on the difference between a long-term and a short-term interest rate. Traditionally, the long-term rates are higher than short-term rates, which explains the attractiveness of this product and reflects the risk linked to the length of the maturities. However, when financial conditions deteriorate, the yield curve often reverses, with short-term interest rates being higher. In this kind of product, the interest rate is fixed as long as the requisite difference between the long-term and the short-term interest rate persists. If the difference narrows by too much, the fixed rate turns into a variable rate. Since maturities are typically long, foreseeing the full budgetary impact of such products is difficult, especially for SNGs without sufficient in-house financial expertise.
The same principle applies to other products: the initial fixed interest rate (which is linked to an index) is attractive to the borrower, but beyond a given threshold of this index, this interest rate increases. Considering that the maturities are long (several decades for the majority of these structured products), the central problem is that interest rates cannot be reliably projected in the long run.

The transition from a fixed interest rate to a variable interest rate can gravely impact SNG financial accounts. In this case, two solutions are possible: to settle borrowers’ accounts or to renegotiate the loans.

In addition, several surveys conducted by RCAs established that SNGs having financial difficulties are frequently those that have exposure to these structured products. The recent evolution of the SNGs’ financial position confirms this. Since 2003, SNG borrowings have had longer maturities, with an increased use of structured products. The increased availability of structured products with combined fixed and variable rate terms has proved to be particularly risky.

Public accounting standards have lagged behind in reflecting the new challenges that these structured products pose for transparency and debt profile. Risks and costs of these products are often not adequately evaluated and understood. In December 2011, a report released by an ad-hoc parliamentary commission estimated that €13.6 billion of SNG structured debt was “toxic,” thereby likely to weaken the financial position of French local governments. Efforts are ongoing to better regulate and restrict the use of structured products.

**Resolving Subnational Financial Distress**

French law distinguishes between private and public law. Private law is the law of coordination and voluntary cooperation, and in private law, the actors are in a horizontal legal relationship. Public law is characterized by vertical legal relationships, with the central government exercising sovereign authority and commanding the legal subjects to act as prescribed. Public law is fundamentally asymmetric. The mechanisms for coping with subnational financial distress are found in administrative law (public law), which emphasizes prevention and oversight by the central government. However, the financial distress of SEMs
(with public ownership between 50 and 85 percent) is subject to private law (including corporate insolvency law).

Before decentralization, subnational defaults in France were extremely rare. Because the decentralized system of subnational finance is less than three decades old, case studies are few. In the early 1990s, one estimate put the number of municipalities experiencing overindebtedness at about 2,000 (out of more than 36,000 municipalities), of which 40 were experiencing severe financial difficulties (Moody’s Investors Service 2002). Other tiers of SNGs (departments and regions) have also experienced subnational financial distress, although there have been few cases. Actually, both domestic and foreign lenders rushed to lend to municipalities, in the mistaken belief that there was little risk because public entities were involved.

After several cases of subnational financial distress in the early 1990s, both the subnational borrowing framework and accounting systems were strengthened, as discussed above. (The risks of structured products materialized only in the 2000s [these products were not previously available]). An early warning system (réseau d’alerte) was launched, and the training of local civil servants was intensified. The overall goal was to achieve greater transparency and disclosure, and thereby reduce municipal financial risk. Recourse to speculative financial instruments was tightly regulated, but these standards were loosened after 2000.

Starting in 2008, the global financial crisis put the finances of French cities and regions under strain. Most of them did not use structured products, even if such borrowing looked attractive. Nevertheless, a growing number of SNGs experienced difficulties when credit markets dried up in the second half of 2008 (Cossardeaux 2008). The subnational borrowing market shrank in volume. The crisis also led to a decrease in tax revenues and tax allocations from the central government. About 1,595 SNGs used structured products that turned out to be toxic. Other estimates are that up to 25 percent of SNG debt used structured products. The French central government committed to help local authorities face their credit needs and pressured banks to accept subsovereign debt restructurings.

Facing a slowdown of their tax revenues and losses related to the slowdown in the real estate market (for example, the droits de mutation [property transaction tax]), SNGs were experiencing a severe credit
crunch in late 2008. The risks of structured products added to these financial difficulties. The crisis in SNG finances may continue for years. Some SNGs may have to choose between cutting investments or borrowing more to fulfill their enlarged responsibilities, thereby jeopardizing their creditworthiness. Ex-ante rules, such as the balanced budget rule or the debt-service-to-revenue ratio, combined with the early warning system, may have reduced the risk of systemic SNG financial distress in the future.

To help SNGs cope with the impact of the global financial crisis, the central government reduced the delay in refunding the value-added tax to SNGs, enabling them to maintain capital expenditures in 2009 above the 2004–07 average. The expected value-added tax refund payments in 2009 totaled more than €4 billion, equivalent to 8 percent of SNG capital expenditures that year. Overall net borrowing by French SNGs increased by €5.1 billion in 2009, while total outstanding debt as a share of GDP increased by 4 percent over 2008. The growing financial difficulties of French SNGs (particularly departments and municipalities) have prompted the central government to establish a new bank that would fund local governments and make an exceptional transfer (of €3 billion to €5 billion) to SNGs in 2012.

The ex-ante regulations and the oversight by the central government, as discussed in previous sections, have substantially reduced the risks of defaults and, thus, uncertainties facing lenders. Nonetheless, fiscal and default risks exist despite ex-ante rules. If an SNG becomes insolvent, the negotiated nature of debt workout and fiscal adjustment cause uncertainty to lenders due to a lack of a priority structure that would have existed with a formal insolvency system. As mentioned, there is no insolvency law that applies to SNGs. Although the procedures for dealing with SNGs that are breaching fiscal rules are clear, the procedure for dealing with SNG defaults is not detailed in legislation, such as the CGCT, but is shaped by administrative practice.

These mechanisms are largely informal, unbounded by legal constraints and with less reliance on precedents than civil law. Even though the payment order mechanism theoretically offers extremely strong security to lenders, it requires sufficient income for the payment of all compulsory expenses. Moreover, lenders have few remedies under civil law, such as seizing SNG assets. Liens on assets that are essential
for the performance of public services are illegal based on the premise that interrupting public services would be counter to the public interest. Similar restrictions exist in other countries, including the United States.

Even though the Prefect and the RCAs have the authority to enforce a recovery plan and to release additional revenue in the case of financial difficulties, these powers have proved insufficient to prevent some municipalities from defaulting. The view that the central government always guarantees subnational debt is incorrect. Nevertheless, under the provisions of articles L. 2335-2 and L. 1524-4 of the CGCT, there is a procedure for exceptional state aid for SNGs in financial distress. Article L. 2335-2 states:

Under the provisions of article 1524-4, exceptional subventions can be granted by Ministerial order … to municipalities in which unusual circumstances have led to specific financial difficulties.

In reality, the amount of extraordinary aid has been small. In 2006, only 12 municipalities benefited from these subsidies, for a total of €1,593,682 (Robert 2009). The allocation of these subsidies is subject to three conditions: (a) a municipality can receive exceptional subsidies only if the budget is unbalanced (as defined in article L. 1612-4 of the CGCT), (b) this imbalance led to a case before the RCAs (indeed, the subsidies can be granted only after the audit of the budget by the RCAs), and (c) the recovery measures taken by the Chamber must have been inefficient (they cannot absorb the deficit of the operating budget).

The Ministry of Home Affairs and the Ministry of Finance have compiled a list of subnational entities in financial distress. However, there is no power of coercion against an entity that refuses to cooperate with a restructuring plan. A subnational entity cannot be placed under supervision a priori. The current framework reaches its limits in cases of extreme financial distress; that is, there is no established procedure for restructuring debt with lenders that are unwilling to cooperate. In crisis, there is a three-party negotiation system: the central government, SNGs, and lenders (only a limited number of banks lend to SNGs). It is a predictable negotiation system, even though the outcome of the negotiation depends on the balance of power among three parties. Notwithstanding
the above, there is no rules-based framework for dealing with subnational financial distress, and the nature of the policy response may thus differ from case to case.

The implementation of an early warning system began in 1993 and only applied to municipalities of more than 10,000 inhabitants. The Direction Générale des Collectivités Locales (General Directorate of Subnational Entities, DGCL) and the Direction Générale de la Comptabilité Publique (General Directorate of Public Accounting, DGCP) had each developed a system to analyze the accounts of municipalities to detect financial distress. The two systems were based on the analyses of certain ratios, which are presented in Table 6.4.

Under the DGCP system, the financial situation of a municipality is considered to be critical if it exceeds three thresholds, and extreme if it exceeds four thresholds, as explained below.

The DGCP and the DGCL later realized the efficiency of their system was limited, for two reasons: the system was centralized nationwide, and the number of ratios was excessive. In this respect, the revision of the warning system in 2001 was based on implementation of this system in all municipalities, the decentralization of the system at the departmental level, and the simplification of the ratios system, with four ratios inspired by the initial DGCP system. Each ratio has a critical threshold and rates the municipality on a scale of zero to 100. The situation is considered critical when the ratio falls below 30, and extreme when it falls below 20. The list of municipalities in financial distress is sent to the Prefect, who has the option of intervening, of providing such information to the RCA, or both. The results are for the mayor’s private

| Table 6.4 Main Ratios Used by the French Central Government to Detect Financial Distress |
|---------------------------------|---------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Ratios                          | DGCL                            | DGCP            | Ratios                          | DGCL                            | DGCP            |
| Indebtedness and financing       | 4 ratios                        | 1 ratio         | Budget structure and rigidity   | 2 ratios                        | 1 ratio         |
| Fiscal pressure                  | 1 ratio                         | 1 ratio         | Rigidity of structural expenses | 1 ratio                        | 1 ratio         |
| Excessive debt                  | 1 ratio                         | 1 ratio         | Fiscal leeway                   | 1 ratio                        | 1 ratio         |
| Method                          | Qualitative evaluation          | Implementation of quantitative thresholds |


Note: DGCL = Direction Générale des Collectivités Locales (General Directorate of Subnational Entities), DGCP = Direction Générale de la Comptabilité Publique (General Directorate of Public Accounting).
information (publication is at his or her discretion), and the list of the concerned critical municipalities is centralized through the DGCP and the DGCL. In the most extreme cases, the departmental treasury can conduct an additional audit.

Generally, caution must be used when assessing the creditworthiness of SNGs. Ratios taking into account the local population are not necessarily accurate, because most local revenues come from firms and not from householders. The most reliable indicators are discretionary own-source revenues to operating revenues, the total debt to operating revenues, and the debt-service-to-operating-revenues ratios. Also worth considering is the taxing capacity and assessing to what extent the SNG is able to increase taxes.56

There is a question as to whether SNGs use structured products to engage in speculation57 or to actively manage debt. In practice, distinguishing between speculation and optimization of debt is difficult. Risky borrowing just after elections provides a measure of budgetary freedom to the new executive. At the same time, it creates an electoral cycle in SNG investments, and thus substantial fiscal risk. According to one view, banks and SNGs share the blame. Banks object, saying that SNGs took advantage of the lower interest rates provided by structured products in the past and must live up to their responsibilities when circumstances change. They also claim that the current situation is exceptional due to the global financial crisis.

The recent growth in structured products used by a growing number of French SNGs poses additional challenges to the resolution of financial distress. The growth of structured products combined with the financial crisis has increased the risks of financial distress. The government has begun to address the challenges of structured products. In its report, “Les risques pris par les collectivités locales et les établissements publics locaux en matière d’emprunt,” (National Court of Accounts 2009b), the National Court of Accounts stresses three points on how to improve SNG debt management.

First, the role of elected assemblies needs to increase. Currently, the CGCT grants the regions, departments, and municipalities considerable freedom regarding the operations they consider necessary, and there are no specific measures regarding structured products. According to
the Court, it would be advisable to structure and redefine precisely the delegation of power to these assemblies.

Second, improved accounting and transparency is needed. Indeed, the accounting norms enforceable to SNGs do not at present include any specific accounting framework for structured products. Moreover, the lack of accounting of the risks linked to the possession of structured products seems to be in contradiction to the general principle of caution, as defined in the General Accounting Plan (Article 120-3).

Third, since decentralization abolished direct control by the central government over SNG actions, and especially over their borrowing, there is a need to improve the openness of SNG policies. Indeed, since SNG goals reflect the intentions of the party in power, communication between citizens and deliberative assemblies must be improved. In this regard, the SNGs could make available to citizens reports that could inform their choices.

In 2008, a tripartite meeting gathered representatives of banks, SNGs, and the Minister of Home Affairs. They decided to treat the difficult cases individually. The minister insisted on better information by comparing the financial situation of all SNGs. Another emphasis was on transparency: banks are subject to stress tests and must keep politicians abreast of the financial situation. After the meeting among the representatives of the central government, the SNGs, and the banks, agreement was reached in November 2008 on two propositions: (a) dealing with subnational financial distress is the responsibility of the concerned SNG and its banks, and (b) a code of good conduct is to be developed to provide a framework for the relationship between the banks and the SNGs.

In May 2009, the Ministry of Finance proposed a code of good conduct. Under it, banks may not sell structured products to SNGs that risk a loss of capital, or risky products indexed to volatile variables such as exchange rates. Banks must indicate the position of their products on a predetermined risk scale. These measures preserve much of the autonomy of SNGs. The fact that they are not binding illustrates the ad-hoc nature of the policy response to relatively widespread subnational financial distress, and the reluctance of the central government to develop a more structured framework.
Both banks and SNGs agreed on several points: (a) SNGs should actively manage their debts without a priori control by the central government; (b) competition among banks should be maintained; and (c) a balance should be reached between financial innovations and constraints specific to public administration. The agreement took effect on September 1, 2009, and the elements, called commitments, contained therein are as follows:

**Commitment 1:** Banks promise not to sell products whose principal payment is risky or linked to risky indexes. Risky indexes include an exchange rate in a currency not held by the SNG, prices of raw materials, and equity investments. It is also forbidden to sell products linked to indexes not related to the SNG investments or those from a non-Organisation for Economic Co-operation and Development country.

**Commitment 2:** Banks commit not to sell products with cumulative products that are particularly sensitive to interest rate shocks.

**Commitment 3:** Banks accept the requirement to provide a transparent index of riskiness when proposing products. Each product is rated on two common scales of five levels each. One scale refers to the riskiness of the index the product is linked to, and the other refers to the structure of the product. This should increase the transparency in comparing structured products.

**Commitment 4:** Banks acknowledge that SNG executives do not have financial expertise and that the executives should be well informed at all times. All the documents should be in French. The drawbacks and the risks of each product should be clearly shown. Past behavior of the indexes should be analyzed. Stress tests should be conducted showing how the product behaves in case of sharp corrections of the index.

**Commitment 5:** SNGs commit to improving the transparency of the decisions taken regarding borrowings and debt. SNG executives should present the current financial
situation to the entire municipal council. The council may authorize the executive to buy products of a certain risk level on the two scales.

**Commitment 6:** SNGs commit to make public the structured products they subscribe to, the indexes they are linked to, and the structure of the products. This increased transparency should improve the decisions taken in the budgetary meetings. The executives should receive authorization from the municipal council before committing to a new product.

Former French president Nicolas Sarkozy created a *Comité pour la réforme des collectivités territoriales* (Committee for the Reform of Territorial Entities) at the end of 2008 to “determine measures to simplify SNG structures, to clarify the distribution of their competences and to allow a better allocation of their financial means, and to formulate useful recommendations.” 61 Twenty propositions were presented by the committee to the president on March 5, 2009, (Rapport Balladur 2009). Regarding the simplification of SNG structures, the committee suggests reducing the number of metropolitan regions from 22 to 15. Abolition of the departments is not planned, but the report insists on the necessity of redefining the competencies of existing departments. At the municipal level, the prerogatives of the mayors are not modified, but the committee intends to strengthen the intermunicipal cooperation structures. Between 2009 and 2014, a new land allocation and new voting system could be implemented.

**Conclusions**

During 1982–83 and 2003–04, two waves of decentralization in France devolved more powers to the three levels of SNGs: the municipalities, the departments, and the regions. This new institutional framework has enabled SNGs to enjoy a greater degree of autonomous expenditures, to raise their own taxes, and to borrow from financial markets, within ex-ante rules established by the central government. However, SNGs are subject to ex-post controls by the Prefect and the Regional Chambers of Accounts, and to ongoing controls by the Public Accountants.
The ex-ante fiscal rules and the regulatory framework for managing SNG fiscal risks were established after a period of unregulated borrowing by SNGs following the decentralization and subsequent debt stress experienced by some SNGs. The regulatory framework combines the laws and regulations with three sets of institutions, while preserving considerable SNG fiscal autonomy. The laws and prudential rules regulate debt, liquidity, and contingent liabilities. The state exercises strong supervision and monitoring of SNG financial accounts through the Prefect, the Regional Chamber of Accounts, and Public Accountants.

The French system, which combines decentralized responsibilities and fiscal decisions with fiscal monitoring by the central government, offers valuable experience for countries undergoing decentralization. State supervision has resulted in the avoidance of major SNG defaults—although several debt restructurings occurred in recent decades, which partly explains the high credit ratings—“AA,” on average—assigned by rating agencies. Nonetheless, the lack of a clear, established legal structure for priority payments creates uncertainties. Off-budget entities, such as SEMs, pose contingent fiscal risks, a common challenge across countries.

Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

1. Standard & Poor’s downgrading of France’s sovereign credit rating in January 2012 (Standard and Poor’s 2012) will have implications for subnational finance in France; the assessment of such implications is beyond the scope of this chapter.

2. In this chapter, the term local authorities and the term subnational governments are used interchangeably.

3. Titre XII: Des Collectivités Territoriales (Title XII: Territorial Entities).


5. Article 74 of the French Constitution. The four regions are French Polynesia, Guyana, New Caledonia, and Wallis and Futuna. The four departments are Corsica, Guadeloupe, Martinique, and Reunion Islands.

6. The Law of March 2, 1982, known as the “Defferre Law,” because Gaston Defferre was then Minister of Home Affairs.
7. Laws are referred to by date in this chapter.
8. Article 1 of the Constitution.
9. Article 72 of the Constitution.
10. Article 72-2 of the Constitution. The terms are defined under the constitutional law of July 29, 2004.
11. Article 72 of the Constitution.
12. Articles 72 and 72-1 of the Constitution.
15. DGCL (Direction Générale des Collectivités Locales) 2011.
16. Law on Inter-Municipal Bodies of July 12, 1999 (also called the Chevènement Law).
19. Because their assets are immune from attachment, public establishments are not subject to the liquidation law of January 25, 1985.
20. DGCL 2011.
22. The business tax was abolished in 2010 and was replaced by the Territorial Economic Contribution (Contribution Economique Territoriale).
23. The central government reduced the delay in refunding the value-added tax to SNGs, enabling them to maintain capital expenditures in 2009 above the 2004–07 average. The expected value-added tax refund payments in 2009 was more than €4 billion, equivalent to 8 percent of SNG capital expenditures in 2009. Overall net borrowing by French SNGs increased by €5.1 billion in 2009, while total outstanding debt as a share of GDP increased by 4 percent over 2008. However, debt accounts for only 4.2 years of overall SNG current balance.
24. These 11 departments are Ardennes, Cher, Corrèze, Creuse, Haute-Loire, Haute-Saône, Indre, and Meuse (which are rural and poor departments), and Pas-de-Calais, Seine Saint-Denis, and Val d’Oise (which are urban and poor departments).
25. For instance, the number of beneficiaries of the Active Solidarity Income (Revenue de Solidarité Active) in the department of Seine-Saint Denis increased 41 percent from 2008 to 2009.
26. An example of an SNG with an unbalanced budget is Seine-Saint Denis which, in April 2010, voted an unbalanced budget to protest the abolition of the professional tax and the reduction of transfers from the central government.
27. Compulsory expenditures include wages of local civil servants; SNG financial contributions to local-interest services; maintenance of the city hall, roads, and cemeteries; and debt services.

29. The National Court of Accounts and the Regional Courts of Accounts constitute a separate judicial branch in administrative-financial matters.

30. L. 1612-14 CGCT provides that if the projected deficit exceeds 10 percent of operating expenses for a municipality with less than 20,000 inhabitants, or 5 percent for other municipalities, the Regional Chamber of Accounts recommends measures, on request of the Prefect, to reestablish budgetary equilibrium within a month.


32. Pont-Saint-Esprit is a municipality of 9,523 inhabitants. The Regional Chamber of Accounts of Languedoc-Roussillon in 2006 began implementing several actions to cope with Pont-Saint-Esprit’s financial distress, such as an audit of Pont-Saint-Esprit financial management during 1999–2005.

33. The 1962 Public Accounting Regulations specify this principle of separation.

34. In the area of education, an important public function in France, Public Accountants are appointed by the Minister of Education. Otherwise, there are Public Accountants at the three SNG levels (municipalities, departments, and regions); they are, respectively, the *receveurs municipaux* (municipal public accountant), the *payeurs départementaux* (departmental public accountant), and the *payeurs régionaux* (regional public accountant).

35. The State Treasurer services also audit local public finances management of only municipalities with a population under 3,500 inhabitants whose operating revenues are under €750,000.

36. These two public financial institutions are *la Caisse des Dépôts et Consignations* and *la Caisse d’aide à l’équipement des collectivités locales*.

37. This figure includes SNGs and public-private enterprises.

38. Article D. 1511-32 of the *Code Général des Collectivités Territoriales*.

39. Article D. 1511-34 of the *Code Général des Collectivités Territoriales*.

40. Article L. 1614-4 of the CGCT.

41. Law of May 15, 2001, *Nouvelles régulations économiques* (New Economic Regulations), authorizes SNGs to issue short-term negotiable debt instruments with a minimal nominal value of €150,000 and a maximum duration of one year. These instruments are not considered to be long-term debt.


44. The successor company is Dexia.

45. Based on interviews with Valérie Montmaur, S&P; and Gilbert Payan, municipality of Aubagne.

46. Most French SNGs do not access the capital market; hence, they are not rated.

47. Since the majority of French SNGs do not access the capital market, relying mainly on bank loans, the rated SNGs may represent the most creditworthy borrowers.
48. An example of this fiscal risk can be seen in the municipality of Levallois-Perret. In the late 2000s, the city faced acute financial woes. The costs of running the city increased much more rapidly than receipts, due mostly to increased investment and personnel expenses. Though there was room for raising taxes, the city’s self-financing capacity in 2006 remained unchanged relative to 2002. The municipality relied increasingly on borrowing. The biggest source of contingent liability stemmed from urban development operations. The municipality owns, de facto, 80 percent of three public limited companies and 15–80 percent of another 40 commercial companies. Some SEMARLEP activities, such as real estate sales, are outside the competences of SNGs and their government-owned corporations. Yearly reports appear to contain insufficient information for the municipal council to understand either the true financial stakes of the group’s activities or the indirect commitments and the risks flowing from them. Source: National Court of Accounts Report (2009b).

49. The National Court of Accounts 2009b.

50. This amount accounts for 58.4 percent of total SNG structured debt (see Crouzel 2011).


52. Statement of financial executive Wallace O. Sellers before the Subcommittee on Economic Stabilization of the U.S. House Committee on Banking, Currency and Housing, October 22, 1975, 1418. (“In England or France, it would be unthinkable for a major city to go bankrupt. In France, with a highly centralized system developed under Napoleon, the state exercises substantial control over the finances of SNG units.”)

53. One example is the municipality of Saint-Étienne, whose heavy exposure to financial derivatives was discovered in 2008. Facing a skyrocketing debt in the 1990s, the municipality tried to smooth the payoff by actively managing the debt through structured products (“Saint-Étienne: dégonflement programmé de la dette,” Les Echos, July 7, 1994). The central government did not want to intervene because this could create a precedent of a moral hazard (“Pas de dérogation pour Saint-Étienne,” Les Echos, April 15, 2009a). There were calls for a more structured legal framework and the creation of a “bad bank” in order to get rid of all the toxic products (“Saint-Étienne veut une régulation plus stricte qu’une charte,” Les Echos, May 29, 2009b).


56. This view is advocated by Michel Klopfer, an independent consultant who specializes in local finances (see Klopfer 1996).

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58. Article 120-3 of the General Accounting Plan.

Bibliography
