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What Can LICs Learn from MICs?
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Subnational debt management is emerging as an important public policy agenda for low income countries (LICs), propelled by the changing financial landscape and the ongoing decentralization in these countries. The macroeconomic fundamentals in LICs have significantly strengthened during this decade, with marked improvement in debt dynamics, significant reduction in public indebtedness, and stronger external positions as reflected in increased foreign exchange reserves. Along with the initiatives for debt relief in highly indebted poor countries (HIPC) and (until recently) a favorable global financial environment, these improvements have led to the emergence of new creditors, new sources of financing, and expanded opportunities for accessing market financing, the recent market conditions notwithstanding. And international rating agencies are rating an increasing number of LICs for creditworthiness, as a precondition for accessing the market.

Decentralization has increased the share of subnational finance in consolidated public finance in many LICs. With sovereign access to external markets, subnational access is likely to follow, particularly given the rising regional and subnational political power which is a driving force in decentralization. And even without that access, subnational governments could resort to domestic borrowing, including borrowing via off-budget activities (such as special purpose vehicles and public utility companies), which is already a problem in many LICs. With decentralization, the off-budget borrowing by companies affiliated with subnational governments is likely to pose a special risk.

These twin trends – a changing financial landscape coupled with decentralization – present both opportunities and challenges for subnational governments to access markets to finance infrastructure and other public services. Experience from middle income countries (MICs) suggests that subnational borrowing offers numerous benefits particularly for facilitating infrastructure financing to match the maturity of debt with asset life for more efficient and equitable financing.

But experience from MICs also suggests that unregulated borrowing by subnational entities creates substantial fiscal risk. During the 1990s, subnational fiscal stress and debt crises threatened macroeconomic stability in Argentina, Brazil, India, Mexico, and Russia. The risk arises principally from borrowing to finance operating deficits, risky debt structures, or large contingent liabilities. Imprudent borrowing not only threatens service delivery at the subnational level, but also produces negative macroeconomic spillovers for the central government and other subnational governments. MIC experience such as that of Hungary and Russia shows that the risks are high during the initial stage of fiscal decentralization, which has started recently in some LICs. These risks are further exacerbated if decentralization is accompanied by episodes of macroeconomic instability and unregulated financial markets.

Although the dynamics of national and subnational debt are alike, critical differences exist; a regulatory framework for subnational borrowing and debt management must be developed in the context of these differences. Subnational debt sustainability is complicated by the legislative mandates of central vis-à-vis subnational governments, and the intergovernmental finance system. Unable to issue their own currency, subnationals cannot use seigniorage finance; nor can they freely adjust their primary balance because of potential legal constraints on raising own revenue, dependence on central government transfers, and central government's influence on key expenditures, such as wages and pensions.

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In addition, the principal-agent problem is particularly potent for subnational borrowing, and the threat of the soft-budget constraint weakens competitive incentives and fosters corruption and rent-seeking. For instance, bailouts of insolvent subnational governments can undermine the effectiveness of subnational borrowing regulations. Market participants may tolerate unsustainable fiscal policy of a subnational government if history backs their perception that the central government implicitly guarantees the debt service of that government. Worse, banks may act as implicit agents of the nation by lending to un-creditworthy subnationals with the expectation of bailouts in case of trouble.

MICs increasingly recognize that a well-designed regulatory framework for all subnational borrowing helps preempt soft-budget constraint, strengthens fiscal discipline, better aligns incentives of both borrowers and creditors, supports broader intergovernmental fiscal reforms, and encourages the efficient use of capital. Such regulation, by hardening the budget constraint for fiscal irresponsibility, helps subnational governments fulfill their broader public responsibilities as self-standing borrowers.

The pace of developing a subnational borrowing framework varies cross MIC. Subnational borrowing regulation generally consists of two complementary elements: ex ante control of the type, amount and procedure of borrowing, and an ex post mechanism for debt restructuring in the event of insolvency. Insolvency procedures allocate default risk between borrower and lenders, and provide a collective framework for debt restructuring and fiscal adjustment, strengthening the effectiveness of ex ante rules and the delivery of essential public services even in financial distress.

Furthermore, an active subnational debt management strategy highlighting cost-risk trade offs complements the regulatory frameworks. Unlike borrowing by the national government, borrowing at the subnational level can be affected by low liquidity and fragmentation: debt issuance at the subnational level implies multiple issuers of securities with varying claims to sovereign creditworthiness that may fragment the market and reduce its liquidity and efficiency.

MIC experience indicates that the subnational borrowing framework needs to be tailored to the evolution of a country's subnational borrowing market, especially to its shortcomings. The borrowing and debt management frameworks should be embedded in a country's existing political, legal, and intergovernmental system, particularly when the insolvency framework needs to define the respective roles of legislative, executive, and judicial branches in subnational fiscal and debt adjustment. Institutional and capacity differences can also affect the entry point for reform.

Introducing transparency should be a policy priority. Off-budget liabilities, notwithstanding their potential to finance urgently needed infrastructure, present tremendous fiscal risks. As part of ex ante regulations, subnational governments in MICs are increasingly required to develop a medium-term fiscal framework, improve fiscal transparency, and strengthen the timely availability and independent audit of fiscal accounts, including implicit and contingent liabilities.

To conclude, the experience in MICs highlights the importance for LICs of developing a regulatory framework for subnational borrowing and a debt management strategy for sustainable subnational infrastructure finance and macroeconomic stability. IFIs offer a range of advisory services and products to governments in the management of their public debt portfolios. Among these, the debt sustainability framework, cross-country experience in regulatory frameworks for subnational borrowing, debt management performance assessment (DeMPA) and medium-term debt management strategies (MTDS) are relevant to LICs' efforts to develop appropriate frameworks for subnational debt management.