

Managing Subnational Fiscal Risks Briefing Note for APEC Meeting¹

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Widespread decentralization has granted significant spending responsibilities, taxation power, and borrowing capacity to subnational governments in developing countries. For example, in China, subnational governments undertake about 80 percent of total government spending. In Indonesia, about 50 percent of recent public investments and discretionary spending are undertaken by subnational governments. Thus, the public balance sheet needs to expand to include the activities of subnational governments. In particular, fiscal risks need to include potential risks from subnational fiscal activities.²

This briefing note focuses on managing subnational fiscal risks arising from borrowing. Allowing subnational governments to access the capital market offers numerous benefits. Yet, left unregulated, subnational borrowing entails the risk of insolvency, which threatens local service delivery as well as macroeconomic and financial system stability.

The way forward is to develop institutional frameworks for managing subnational fiscal risks. Specifically, a regulatory framework can help expand subnational borrowing, strengthen subnational fiscal discipline, and manage potential risks, while at the same time support reforms in the intergovernmental fiscal system and financial markets for efficient utilization of capital.

Benefits and risks of subnational borrowing

Allowing subnational governments to access the capital market expands fiscal space for infrastructure investment. The unprecedented scale of urbanization in developing countries requires large-scale infrastructure financing much beyond fiscal transfers and subnational own-tax revenues. Moreover, future generations benefit from infrastructure investments, therefore they should pay for the cost of provisions. Matching infrastructure asset life to debt maturity is a sound public policy. Furthermore, subnational governments are exposed to creditworthiness assessment by independent credit rating agencies, thus strengthening market discipline, fiscal transparency, and good governance.

Expanding subnational borrowing also facilitates financial market deepening. The subnational debt market in developing countries is going through a notable transformation. Private capital has emerged to play an important role and bonds increasingly compete with traditional bank finance, both trends are facilitated by mobility of international capital and diversification of financial instruments. A competitive subnational credit market with a variety of buyers and sellers and financial options helps lower borrowing cost and improve public service delivery.

¹ This briefing note is prepared by Lili Liu, Lead Economist, Economic Policy and Debt Department at the World Bank, drawing on work by Lili Liu and Michael Waibel (2007) “Subnational Insolvency: Cross Country Experiences and Lessons,” in *Managing Subnational Finance*, forthcoming, International Monetary Fund and “Subnational Borrowing, Insolvency and Regulation,” in *Macrofederalism and Local Finance*, forthcoming, World Bank.

² The term subnational here refers to all tiers of government and public entities below the federal or central government which have the capacity to incur debt.

Notwithstanding the benefits, risks to subnational borrowing exist in the absence of an effective regulatory framework, as manifested by subnational debt crises in the 1990s in countries such as Brazil, Mexico, and Russia, and by subnational fiscal stress in countries such as Colombia, Hungary, and India. Understanding the root causes of the stress and crises helps develop an effective subnational regulatory framework that can minimize the occurrences of systemic crises.

Although expenditure-revenue imbalances may cause subnational fiscal and debt stress, other contributing factors include: unregulated borrowing, which is particularly risky in an uncertain macroeconomic environment; borrowing to finance operating deficits; increased spending on subsidies; imprudent lending based on implicit guarantees from the central government; failure to subject subnational governments to the discipline of the capital market; risky debt profile (e.g., short maturity, high debt service ratios, and variable interest rates); and weak incentives for public banks to price risks and returns. For a newly decentralizing country, unfettered market access by subnational borrowers, especially in speculative and unregulated security markets, can outpace the development of sound revenue streams and a regulatory framework.

Contingent liabilities can lead to the sudden onset of fiscal crises without warnings. The types of hidden and/or contingent liabilities, varying across countries, include: off-budget liabilities of special purpose vehicles, opaque transactions between subnational governments and their enterprises, guarantees to support market borrowing of loss-making public enterprises, subnational civil servant pension liabilities under the pay-as-you-go system, non-performing assets of banks owned by subnational governments, and the cash-reporting system that underestimates financial liabilities such as arrears to suppliers, contractors, as well as delayed payments in civil servant wages and pensions.

The soft budget constraint, a key aspect of fiscal incentives, allows subnational governments to live beyond their means, negating competitive incentives and fostering corruption and rent seeking. Sub-national debt markets have three agency problems: subnational borrowers as agents have an incentive not to repay their lenders as principals if they anticipate bailed-outs; subnational borrowers as agents have an incentive not to reveal certain characteristics about themselves to lenders as principals, resulting in adverse selection; and banks are implicit agents of the nation, entrusted to maintain the nation's payment system and creditworthiness, and they often abuse this trust by lending to uncreditworthy subnational governments with the expectation of bailouts by the national government in case of trouble. The incidence of these agency problems varies considerably across countries.

Rationales for regulating subnational borrowing

The development of regulatory frameworks for subnational borrowing in developing countries since the late 1990s is the direct result of, and response to, subnational fiscal stress and debt crises. Regulatory frameworks should contain two parts: ex-ante control specifying purpose, types, amount and procedures of borrowing, and ex-post debt restructuring in the event that subnational governments become insolvent. The regulatory frameworks in many countries are still evolving and the pace of putting together a full range of regulatory elements varies.

Ex-ante borrowing regulation and ex-post insolvency mechanisms complement each other. Insolvency mechanisms increase the pain of circumventing ex-ante regulation for lenders and subnational borrower, thereby enhancing the effectiveness of preventive rules. Over reliance on ex-ante regulations, including central government approval of individual loans, limits the role of markets in monitoring subnational borrowing and debt. Although it is not realistic for developing countries to rely heavily on capital markets for monitoring subnational borrowing, developing countries should aim at fostering the role of market when designing regulatory frameworks.

Subnational borrowing legislation functions as a commitment device to allow subnational governments to access the capital market within a common framework. An individual subnational government may adopt unsustainable fiscal policies for a variety of reasons. There are inherent incentives for a subnational government to free ride – it bears only part of the cost of unsustainable fiscal policies, but it alone receives all benefits. Realization of these benefits depends on good fiscal behavior by most of the other subnational governments. So, collectively governments benefit from a system of rules to discourage such defection and free-riding.

A well-designed insolvency mechanism helps enforce the commitment device and hard-budget constraints on subnational governments. Equally important, insolvency procedures help an insolvent subnational government to maintain essential services while restructuring its debts. As subnational governments perform public functions, they cannot be liquidated and dissolved like private corporations. Reorganization is the essence of insolvency for public entities. Ultimately, subnational governments need to reenter the capital market.

The insolvency proceeding must be fair to creditors; it ought to protect creditor rights, which are crucial to developing capital markets, lowering borrowing cost and extending debt maturity. To balance the interests of creditors and the debtor, insolvency mechanisms establish a set of pre-determined rules to allocate default risk. These rules anchor the expectations of both borrowers and lenders that both sides share the pain of insolvency. Pressures for political ad-hoc intervention decrease, as restructurings become more institutionalized. Enhanced credibility for the no-bailout promise better aligns incentives. Effective insolvency and creditor rights systems allow better management of financial risks.

The need for collective framework for resolving debt claims is even greater in the context of subnational insolvency. Creditors' remedies under contract law (instead of insolvency mechanisms) are effective to enforce discrete unpaid obligations, but fail if there is a general inability to pay. Individual ad hoc negotiations are costly, impracticable, and harmful to the interests of a majority of creditors. The holdout problem is not as serious if debts are concentrated in a few banks. However, a collective framework for insolvency restructuring takes on more importance as the subnational bond markets develop with thousands of creditors.

The motivations for developing regulatory frameworks differ significantly across countries, reflecting a country's political, economic, and legal and historical context, which in combination with triggering events, results in country-specific motivations. These differences affect the entry point for reform, the framework's design and its relation to subnational borrowing legislation. Furthermore, regulatory frameworks are inseparable from the reform of intergovernmental fiscal systems and capital markets as they profoundly shape incentives for subnational governments to

pursue sustainable fiscal and debt policies and for creditors to price returns and risks appropriately.

Frameworks for subnational borrowing: ex-ante regulation

Ex-ante regulation deals with ex-ante control of borrowing and monitoring of the subnational fiscal position. There are various country examples. Mexico introduced a new borrowing framework in 2000 to address the subnational debt crisis triggered by the financial crisis in 1994-1995. The regulatory framework, along with the overall progress in macroeconomic stability, has contributed to the strong development of the subnational credit market in the country. Brazil has substantially strengthened ex-ante regulations in response to repeated waves of subnational debt crises. The strengthened ex-ante borrowing regulations were imbedded in the debt restructuring agreements between 25 states and the federal government in 1997, sanctioned by legislation. The Fiscal Responsibility Law in 2000 consolidated various pieces of legislation into one unifying framework.

Colombia developed a borrowing framework as defined by various pieces of legislation including Law 358 in 1997, Law 617 in 2000 and more recently the Fiscal Transparency and Responsibility Law in 2003. After the state fiscal crises in the late 1990s, the Twelfth Finance Commission in India recommended fiscal rules and targets, and incentives for states to comply with the rules and targets. While embarking on decentralization, Peru developed subnational borrowing rules – the Fiscal Responsibility and Transparency Law in 2003 and the General Debt Law in 2005.

Several key elements are common in ex-ante borrowing regulations across these countries. First, borrowing is allowed only for long-term public capital investments. Many European countries and U.S. states have enacted fiscal laws requiring long-term borrowing only for capital investment (golden rule). This links back to the idea that only such borrowing is beneficial (and maybe in the interest of future generations). A number of middle income countries, such as Brazil, Colombia, India, Peru, Russia, and South Africa, have recently adopted the golden rule.

Second, the frameworks specify limits on key fiscal variables such as fiscal deficit, primary deficit, debt-service ratios, and ceilings on guarantees. In India, a state with debt service ratio exceeding 20 percent is classified as having a debt-stress status, triggering the central government's close monitoring of additional borrowing by the state. Fiscal responsibility legislation requires that revenue deficit be eliminated and the fiscal deficit be reduced to 3 percent of gross state domestic product by fiscal year 2009. Colombia sought to limit subnational debt to payment capacity with a "traffic light" monitoring system. Subnational governments rated in the red light zone are prohibited from borrowing and those in the green light zone are permitted to borrow. In Brazil, the debt restructuring agreements between the federal government and states established a comprehensive list of fiscal targets such as debt to revenue ratio, primary balance, own-source revenue growth, investment ceilings, and state-owned enterprises or banks to be privatized.

Third, several legal frameworks such as those in Brazil, Colombia, and Peru include procedural requirements that subnational governments establish a medium-term fiscal framework and a

transparent budgetary process. This is to ensure that fiscal accounts move within a sustainable debt path and that fiscal adjustment takes a medium-term approach to better respond to shocks and differing trajectories for key macroeconomic variables that impact subnational finance. The transparent budgetary process affords debates by executive and legislative branches on spending priorities, funding sources and required fiscal adjustments.

Furthermore, fiscal transparency is an integrated part of fiscal frameworks. This includes independent auditing and disclosure of subnational financial accounts, exposing hidden liabilities, and moving off-budget liabilities on budget. In India, several reforming states have moved the off-budget liabilities onto the budget. In Brazil, the accrual accounting method for all levels of the government eliminates arrears as a source of hidden liabilities. Its Fiscal Responsibility Law (2000) requires all levels of governments publish a quarterly fiscal management report, certified by the audit courts, containing major fiscal variables and their compliance with fiscal targets.

Ex-ante regulation may not be only on the borrower side. In Mexico, the requirements of the capital-risk weighting of bank loans and of loss provisions aimed at enforcing subnational fiscal discipline through the market pricing of subnational credit. In Colombia, lending to subnationals by financial institutions and territorial development institutions must meet the conditions and limits of various regulations such as law 617 and law 817. Otherwise the credit contract is invalid and borrowed funds must be restituted promptly without interest or any other charges.

Regulatory frameworks for subnational borrowing: insolvency mechanisms

Ex-ante regulation cannot prevent all defaults. Defaults may simply arise due to a subnational's own fiscal mismanagement, and macroeconomic or exogenous shocks. Key design issues concern insolvency procedures include: fundamental differences between public and private insolvency, the choices between judicial or administrative approaches, and the operation of the insolvency procedure itself. The central question is the resolution of the differing interests between creditors and the insolvent subnational borrower, and among creditors.

The public nature of the government services explains the fundamental difference between public insolvency and the bankruptcy of a private corporation. This leads to the tension between protecting creditors' rights and maintaining essential public services. Compared to corporations, creditors' remedies against defaulting subnationals are narrower, leading to greater moral hazard (strategic defaults). While a corporation is able to self-dissolve, this route is barred for subnational governments. When a private corporation goes bankrupt, all assets of the corporation are potentially subject to attachment. But the ability of creditors to attach assets of subnational governments is greatly restrained in many countries. In subnational insolvency, the insolvency mechanism is generally a reorganization type, not liquidation of all assets.

There are two alternative approaches to subnational insolvency: the judicial and the administrative approach. Various hybrids also exist. Judicial procedures place courts in the driver's seat. Courts take key decisions to guide along the restructuring process, including on when and how a municipal insolvency is triggered and a priority structure for allocating credits among competing claims. As the debt discharge is highly complex, the judicial approach has the advantage of neutralizing political pressures during the restructuring. However, the ability of

courts in influencing fiscal adjustment of subnational entities is extremely limited, as mandates for budgetary matters lies with the executive and legislature in many countries. Administrative interventions, by contrast, usually allow a higher level of government to intervene in the entity concerned, temporarily taking political responsibility for many aspects of fiscal management.

The choice of approach varies across countries, depending on history, political and economic structure, and the motivation for establishing an insolvency mechanism. In Hungary, a desire to neutralize political pressure for bailing out insolvent subnational governments favored the judicial approach. South Africa's legal framework for municipal bankruptcy is a hybrid, blending administrative intervention with the role of courts in staying, restructuring, or discharging debt.

In Brazil, after having bailed out insolvent subnational entities in the two earlier debt crises, the federal government chose an administrative approach to dealing with the third subnational debt crisis. The central government intervened in fiscal and debt adjustment, introducing difficult structural reforms, instilled fiscal transparency, and essentially imposed a fiscal and debt adjustment package based on reform conditions.

The U.S. has both judicial and administrative approaches. In response to widespread municipal defaults during the Great Depression, the U.S. Congress adopted a municipal insolvency law in 1937, Chapter 9 of the U.S. Bankruptcy Code. The primary aim was to deal with the holdout problem. It was recognized that the mandamus (a court order obliging public officials to take a certain course of action) is useful for enforcing unpaid discrete obligations; it is ineffective if the municipality is generally unable to pay. Chapter 9 provides the procedural machinery whereby a debt restructuring plan acceptable to a majority of creditors can become binding on a dissenting minority. Many states have adopted their own frameworks for dealing with municipal financial distress, because municipalities are political subdivisions of the states and state consent is a precondition for municipalities to file for Chapter 9 in federal court. Moreover, federal courts may not exercise jurisdiction over policy choices and budget priorities of the debtor.

Judicial or administrative, any insolvency mechanism contains three central elements: defining insolvency trigger for the procedure, fiscal adjustment by the debtor to bring spending in line with revenues and borrowing in line with debt service capacity, and negotiations between debtor and creditors to restructure debt obligations and potential relief.

The development of insolvency triggers is influenced by the legal and political structure of a society. For example, under Chapter 9 of US, a creditor cannot bring a municipality into a federal court against its will, based on the Constitution's 11th amendment. In South Africa, any creditor can trigger the insolvency procedure. Specific legal definitions serve as procedural triggers for initiating insolvency proceedings as well as define eligibility criteria for filing. Generally, the bankruptcy code empowers the bankruptcy court to dismiss petitions not filed in "good faith" (i.e. filing purely for the purpose of evading debt obligations).

Fiscal adjustment is a precondition for financial workouts. Here subnational fiscal adjustment qualitatively differs from national fiscal adjustment. The former is complicated by the respective legislative mandates of central vis-à-vis subnational governments and the intergovernmental fiscal system. Unable to issue their own currency, subnationals cannot use seigniorage finance.

Subnationals cannot freely adjust their primary balance due to legal constraints on raising own revenue, dependence on central government transfers, and central government's potential influence on key expenditure items. If public sector banks dominate lending, lending rates could be subsidized, lending to subnational entities could exceed the statutory requirements, and credit risk concerns could be compromised. Key policies that affect subnational economic growth and fiscal health could be within the purview of the central government.

Debt restructuring lies at the heart of any insolvency framework. In administrative interventions, the higher level of government often restructures the subnational's debt obligations into longer-term debt instruments. Discharges are typically limited to judicial mechanisms as the debt discharge is a major departure from the principle that contracts ought to be fulfilled. An independent judicial mechanism is viewed as well placed to ensure the fairness of discharges. If creditors feel treated unfairly, there is a substantial risk that they will stop lending. Perceptions of "equitable" are likely to differ across countries, as distributional judgments are involved.

The rescaling of debt obligations is a major intervention in contract rights. Insolvency law reconciles this clash of creditor rights and inability to pay. It formalizes the relationship between creditors and subnational debtor in financial distress. Insolvency law closes the legal order by curing previous contractual violations through a new legal act. A procedure for subnational insolvency recognizes that resolving financial distress via mechanisms guided by law is to be preferred over muddling through repeated, costly and often unsuccessful negotiations.

The maturity of the legal system influences the choices of procedure. Implementation of insolvency procedures – in the corporate and the subnational context – rest on the shoulders of insolvency experts and on institutions (courts) resisting political influence and corruption. In many developing countries, limited judicial and administrative capacity may be a binding constraint. The first focus should be on developing institutional ingredients and on training bankruptcy professionals. In countries where the judicial system is embryonic, formal procedural guidelines might be a stepping stone to a fully-developed mechanism.

Conclusions

Many developing countries will continue the decentralization. Large infrastructure demand at the subnational level will also continue. As a result of these two trends, managing subnational fiscal risks is likely to figure high on the policy agenda. With respect to developing subnational borrowing legislation, cross-country experiences offer valuable lessons. While indicating workable solutions, their experiences also highlight potential pitfalls.

A subnational borrowing framework has several complementary components. First, access to capital markets depends on fiscal transparency. Timely availability of comprehensive fiscal information requires disclosure and independent audits of the subnational accounts. Second, ex-ante rules specify the type, purpose and procedures of borrowing. Third, ex-post insolvency mechanisms are essential to the borrowing framework. Clear and predictable rules on priority of repayment allow for faster resolution of financial distress. They increase the pain of circumventing ex-ante rules and thereby enhance the effectiveness of preventive rules.

Subnational borrowing behavior is influenced by the intergovernmental fiscal system and the structure of financial markets. Market participants may tolerate unsustainable fiscal policy of a subnational government if past history backs their perception that the central government implicitly guarantees the debt service of the subnational government. The principal-agent problem between subnational borrowers and creditors is particularly potent and the threat of the soft budget constraint negates competitive incentives and fosters corruption and rent seeking.

Hidden and contingent liabilities impose fiscal risk. A transparent subnational borrowing framework and subnational fiscal management system could substantially lessen those risks, while opening access to capital markets. Such orderly borrowing helps expand fiscal space for infrastructure investment in a world of accelerating urbanization. Financial markets then play a greater role in intermediating savings and investments.

Like ex-ante regulation, subnational insolvency procedures invariably need to be adapted to country-specific circumstances. First, developing countries considering the introduction of subnational insolvency mechanisms might have different policy priorities. Second, peculiarities of each country's intergovernmental fiscal system warrant special attention. Third, not only does introduction of an insolvency mechanism require sequencing with other reforms, it also requires bankruptcy expertise and independent courts, if a judicial approach is preferred. The entry point for reform, including the maturity of the legal system, influences the choices of procedure.

Cross-country experience points to a number of central considerations in designing such ex-post mechanisms. Balancing the tension between creditors' rights and the necessity of continued delivery of basic public services in financial distress requires burden sharing between the subnational debtor and creditors. Well-designed mechanisms underpin hard budget constraints and render the central government's no-bailout policy credible. When restructurings become institutionalized, pressure for political ad-hoc interventions will decrease. The institutional setup differs across countries. Some mechanisms give a central role to courts; others opt for an administrative procedure; and still others combine both into a hybrid mechanism. The chosen design is in large part dependent on country-specific circumstances.

Subnational borrowing regulations alone are not sufficient for sustainable subnational finance. Broader institutional reforms need to proceed in tandem. Foremost is the maintenance of macroeconomic stability and improved country credit ratings, as the sovereign rating binds subnational ratings. The intergovernmental fiscal system impacts the fundamentals of subnational fiscal position. Without increased fiscal autonomy and greater own-source revenues, subnational governments cannot borrow sustainably on their own. Broadening the investor base and introducing competition will increase the availability of capital and lower cost. Introducing competition is particularly relevant for countries where a small number of public institutions dominate subnational lending. To maintain investor confidence, securities law and anti-fraud enforcement need to reach international standards.

Recommended Reading

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