Subnational Debt Management by Low-Income Countries in Transition to Market Access

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Subnational debt management is emerging as an important public policy agenda for low-income countries, for several reasons. First, the financial landscape facing these countries has been undergoing a significant change since the start of the millennium. Macroeconomic fundamentals had improved up to mid-2008, reflecting the reduction in heavy public sector indebtedness, the increase in foreign exchange reserves, and more balanced external accounts. In tandem, new creditors and new sources of financing, particularly the rise of domestic and international nonconcessional financing, expanded opportunities for low-income countries to access market financing at both the national and the subnational level. Reflective of this trend, an increasing number of low-income countries are being rated by international rating agencies. These developments provide opportunities for low-income countries to become market-access countries in the medium to long term.

These positive developments in macroeconomic fundamentals and new sources of financing are being challenged by the ongoing global financial crisis, which underscores the importance of sound regulatory frameworks and strategies for managing subnational borrowing and debt. The uncertain macroeconomic environment requires a careful approach to expanding subnational borrowing, because deteriorating macroeconomic fundamentals could negatively affect the debt structure.
of subnational governments, which in turn could exacerbate macroeconomic fundamentals. Moreover, slower economic growth and revenue shortfalls of national governments are likely to reduce fiscal transfers from national to subnational governments. This is a cause for concern, because fiscal transfers account for the majority share of subnational finance in many developing countries, a situation that is likely to be exacerbated by shortfalls in subnational governments’ own-source revenues. States and municipalities in the United States are struggling financially, and there are signs of stress threatening the fiscal and debt sustainability of subnational governments in a growing number of developing countries.

Second, many low-income countries, including Ethiopia, Nigeria, Tanzania, and others, are continuing to decentralize. As the experiences in middle-income countries suggest, decentralization significantly increases the share of subnational finance in the consolidated public finances. With sovereign access to markets, subnational governments are likely to push for access as well, particularly given growing regional and subnational political power, a driving force behind decentralization. Such access needs to be managed carefully, with proper regulatory frameworks, prudent debt-management strategies, and strengthened fiscal-management capacity. Moreover, off-budget activities (special-purpose vehicles and public utility companies) are already a problem in many low-income countries. The off-budget borrowing by the companies affiliated with subnational governments poses a special risk.

Although it offers numerous benefits, unregulated subnational borrowing entails risks that threaten service delivery and the stability of a country’s macroeconomic and financial systems. Widespread financial distress at the subnational level in several major middle-income countries, including newly decentralizing countries, has led to profound legal and institutional reforms for sound subnational debt management.

This chapter makes recommendations on the legal, regulatory, and institutional frameworks that should be in place before subnational governments access market-based borrowing. It is organized as follows. The first section describes the changing financial landscape and the decentralization trend in low-income countries and examines how these two broad developments, together with the current uncertain macroeconomic environment, call for prudent management of subnational debt. The second section, drawing from Liu and Waibel (2008a, 2008b), shows the benefits and risks of subnational borrowing and discusses ways to enforce borrowing discipline given the moral hazard problem posed by potential bailouts from the national government. The third section discusses how subnational debt management differs from sovereign borrowing and highlights the choices and constraints facing subnational governments as they seek to achieve debt sustainability. The last section summarizes the chapter’s main conclusions and proposes areas for future research.
The Changing Financial Landscape and Decentralization in Low-Income Countries

Two important trends are increasing the need for better management of debt. This section describes both the changing financial landscape in low-income countries and the trend toward decentralizing both authority and responsibility for service provision.

The Changing Financial Landscape in Low-Income Countries

The financial landscape facing low-income countries has been undergoing a significant change since the start of the millennium. Until mid-2008, macroeconomic fundamentals had strengthened, with marked improvements in debt dynamics, significant reductions in public indebtedness, and improvement in countries’ external positions, as reflected by increased foreign exchange reserves and improvements in the balance of payments. Starting in the mid-1990s, the aggregate public debt level in low-income countries fell across all regions except South Asia, which recorded a modest increase over the period.

The downward trend can be attributed to several factors. Among the most significant are debt-relief initiatives, particularly the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI) (figure 14.1).

Figure 14.1 External Debt of and Debt Relief to Low- and Middle-Income Countries, 1990–2007

Note: GNI = gross national income; HIPC = heavily indebted poor countries; MDRI = multilateral debt relief initiative.
Stronger macroeconomic outcomes—especially the lower external debt-burden indicators and, until recently, the favorable global financial environment—led to the emergence of new creditors, new sources of financing, and expanded opportunities for accessing market financing. At the beginning of this decade, official development assistance (ODA) flows were larger than private external flows. Private external flows reached about the same level as ODA flows in 2004 (figure 14.2). In 2007, private capital flows were about twice as large as ODA flows. In addition, some low-income countries tapped international capital markets, and an increasing number of low-income countries were rated by Moody’s and Standard & Poor’s (figure 14.3).

Some of these positive developments have now been put on hold, as foreign investors retrench from low- and middle-income countries during the global financial crisis. Experience from advanced and middle-income countries shows that the risks from unregulated subnational borrowing are exacerbated during periods of macroeconomic uncertainty. For low-income countries, the timing is right to undertake reforms and prepare the sound regulatory frameworks and strategies for managing subnational borrowing and debt, which are only likely to grow in importance.

Decentralization and Subnational Borrowing in Low-Income Countries

The ongoing decentralization in low-income countries is an important driver behind the emerging importance of subnational debt management.

![Figure 14.2 Net Official and Private Capital Flows to Low-Income Countries, 1990–2007](image)

In a number of low-income countries, subnational governments have either issued bonds or used off-budget debt financing (examples include Nigeria, Vietnam, and Zimbabwe) or started to explore the potential to access the market (examples include Ethiopia, Pakistan, and Uganda). Even without accessing the market explicitly, central governments have onlent to subnational governments. Subnational governments have also accessed domestic bank financing through arrangements with or approval from the central government. Regardless of the sources of financing, as long as subnational governments have accumulated debt obligations, the management of such debt obligations—be it implicit, explicit, or contingent—ought to become a part of the framework for consolidated public debt management.

As in many middle-income countries, decentralization in low-income countries gathered momentum in the 1990s. The trend is continuing. Ethiopia, Ghana, Mali, Namibia, Nigeria, Senegal, and Uganda have constitutions that are explicitly prodecentralization and formally recognize the existence of local governments. In these countries, the devolution of power was often viewed as a natural process of dispersing political power more widely or as a more effective way of delivering services.

The early wave of decentralization, in the 1990s, focused largely on political decentralization. Since the start of this decade, low-income countries have been undergoing a second wave of decentralization focusing...
on fiscal decentralization. A World Bank study (2003) of 30 Sub-Saharan African countries finds that about 30 percent of these countries had a high degree of political decentralization, with another 20 percent moderately decentralized.9 The same study finds that only four Sub-Saharan African countries scored high on the level of administrative and fiscal decentralization (table 14.1).10

Studies of Ethiopia, Pakistan, and low-income countries in East Asia also find limited fiscal and administrative autonomy.11 Fiscal decentralization since the start of the decade has focused on increasing subnational financial autonomy, widening the own-source revenue base, and increasing performance-oriented grants to strengthen local accountability (see World Bank 2008d).

As a result of these developments, the share of subnational finance in consolidated public finance has increased. Although comprehensive data are not available, the rising share of subnational finance has been observed in a range of countries.12 For example, the share of subnational government budget spending in the consolidated public budget doubled in Nigeria between 1999 and 2005, rising from 23 percent to 46 percent (World Bank 2007). In Uganda, this share increased nearly threefold during the same period (Steffensen 2006). In Vietnam, the share doubled between 1992 and 2002, to 48 percent of the consolidated public budget (World Bank 2005b). Across a range of selected countries, the median

Table 14.1 Decentralization in Selected Sub-Saharan African Countries

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<th>Administrative decentralization</th>
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value of subnationals’ expenditures in the consolidated public budget is about one-third (figure 14.4).

A main explanation for the rising share of subnational finance in the consolidated public finance across developing countries is the increasing decentralization of key social and infrastructure services. Together with the private sector, subnational governments are the main investors in infrastructure in an increasing number of middle-income countries (figure 14.5).

This pattern is similar to that in more advanced countries, such as the countries of the European Union, where subnational governments contribute two-thirds of gross national capital formation. Although on average national governments still dominate infrastructure provision in low-income countries, local governments have started to play a more influential role in infrastructure decisions.

As subnational governments take on more infrastructure investment responsibilities, they seek out capital markets for infrastructure financing, a trend similar to that observed in developed countries and middle-income countries. Subnational governments in Bolivia, Nigeria, and Vietnam have already issued bonds or contracted loans for subnational capital projects.

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**Figure 14.4 Subnational Government Expenditure in Selected Low- and Middle-Income Countries, Various Years (percentage of total national government expenditure)**

- China: 69%
- Vietnam: 48%
- Nigeria: 46%
- Tajikistan: 32%
- Indonesia: 32%
- Ethiopia: 31%
- Uganda: 28%
- Bolivia: 27%
- Philippines: 26%
- Tanzania: 19.2%
- Thailand: 10%


*Note:* Data for the Philippines, Tajikistan, and Thailand are for 2001; data for China, Indonesia, and Vietnam are for 2002; data for Nigeria and Uganda are for 2003.
For example, the municipality of La Paz in Bolivia issued subnational bonds in foreign currency at the end of the 1990s. The bond issuance did not carry an explicit central government guarantee, but it was secured by a revenue stream from a portion of property and automotive taxes. These bonds were earmarked for infrastructure improvements; the municipality even specified in its public offer the cost breakdown for the eight public infrastructure projects (IDB 2000).

State governments in Nigeria are allowed to issue debt in domestic markets by contracting loans and issuing securities and are allowed to provide guarantees.15 Provincial governments in Vietnam have also borrowed domestically by issuing bonds and contracting loans.16 By the end of 2006, 3 of 64 provinces (Ho Chi Minh City, Hanoi, and Dong Nai) had issued municipal bonds, together mobilizing about $614 million (7 percent of total public bond issues in Vietnam) (IFC 2007). The level of subnational debt in Vietnam has been relatively modest, but given the serious deficiencies in and needs for infrastructure investment at the subnational level across the country, the government expects this level of debt to increase (World Bank 2005b).

In sum, the changing financial landscape and the process of decentralization in low-income countries have brought into sharp focus the management of subnational borrowing and debt. Lessons from the experience...

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*Figure 14.5 Share of Total Annual Investment in Infrastructure by Investing Entity in Selected Middle-Income Countries*

![Chart showing investment share by investing entity in selected middle-income countries]


*Note:* Data are for the most recent year available for each country, and they are rounded up.
of middle-income countries are valuable in understanding the causes of subnational debt crises. One important lesson is that unregulated subnational borrowing is particularly risky in an uncertain macroeconomic environment. Open market access by subnational borrowers, especially in speculative and unregulated financial markets, can outpace the development of an effective regulatory framework. Important lessons can also be learned from the ways in which middle-income countries responded to the subnational debt crisis in the 1990s by developing regulatory and institutional frameworks. The purpose of these regulatory frameworks was not to limit or prohibit subnational access to the capital market but to enhance subnational fiscal discipline, ensure debt sustainability, reduce the cost of borrowing, and promote sustainable infrastructure finance.

**Regulatory Frameworks for Subnational Borrowing**

Access to financial markets offers subnational governments an opportunity to finance their infrastructure and promote fiscal transparency. Such benefits can be realized, however, only when the risks of subnational borrowing are managed through regulatory frameworks. Such frameworks help mitigate the risks of default, establish credibility about the subsovereign government among market participants, and help reduce borrowing costs.

**Benefits and Risks of Subnational Borrowing**

Borrowing by subnational governments expands the financial resources needed to finance infrastructure. Pressing demands for infrastructure—particularly urban infrastructure—will continue to rise as cities strive to be successful conduits for innovation and growth while absorbing massive influxes of people from rural areas. The unprecedented scale of urbanization in developing countries requires large-scale infrastructure financing. Many infrastructure investment responsibilities have been decentralized to subnational governments. Borrowing enables local government to capture the benefits of major capital investments immediately, rather than having to wait until sufficient savings from current income can be accumulated to finance them. Financing infrastructure through debt instruments allows borrowers to match the maturity of the debt with the economic life of the assets the debt is financing. Because infrastructure investment benefits future generations, they too should bear their cost. Matching asset life to maturity is sound public policy, because these infrastructure services can be paid for by the beneficiaries of the services.

Given the limited fiscal resources from own-revenues and fiscal transfers from the national government, subnational governments in middle-income countries are increasingly tapping the financial market to finance...
infrastructure. With the long-term objective of developing competitive financial markets in developing countries, a subnational credit market with numerous buyers and sellers and financial options can encourage competition and reduce borrowing costs. Over time, prime-rated subnational bond issues may become the dominant points of reference for establishing a yield curve for other subnational issuers. Developing a diversified and competitive subnational credit market has been a policy objective since the ending of the apartheid regime in South Africa, for example (see Liu and Waibel 2008b).

Notwithstanding these benefits, there are substantial risks to subnational borrowing in the absence of an effective regulatory framework. Low-income countries can benefit from lessons from recent subnational debt crises in middle-income countries such as Argentina, Brazil, Mexico, and the Russian Federation. Although India, for instance, has not yet experienced explicit and systemic subnational insolvency, the subnational fiscal stresses and contingent liabilities Indian states faced in the late 1990s can also be instructive. Understanding the root causes of fiscal stress and debt crisis helps policy makers develop regulatory frameworks that directly address these causes.

Subnational borrowing behavior is strongly influenced by the design of the intergovernmental fiscal system and the structure of financial markets. Soft budget constraints, a key aspect of fiscal incentives, allow subnational governments to live beyond their means, weakening competitive incentives and fostering corruption and rent-seeking. According to Webb (2004), subnational debt markets have three important agency problems: subnational borrowers as agents have an incentive not to repay their lenders as principals if they anticipate bailouts; subnational borrowers have an incentive not to reveal certain characteristics about themselves to lenders, resulting in adverse selection; and although they are entrusted to maintain the nation’s payment system and creditworthiness, banks 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 depending on the structure of each country’s subnational debt market.

These risks apply not only to the borrowing of subnational governments and their quasi-fiscal entities from the financial market but also to onlending from the central government to subnational governments. Regardless of the sources of borrowing, a soft budget constraint undermines the sustainability of subnational fiscal policy and leads to contingent liabilities for the central government.

Although imbalances between expenditures and revenues may cause fiscal stress, the regulatory framework for borrowing profoundly affects the debt sustainability of subnational governments, because accumulation of fiscal deficits is feasible only if they are financed. Unregulated subnational borrowing grew rapidly in countries such as Hungary and
Russia in the 1990s, contributing to subnational debt overhang. Borrowing by subnational governments in these countries was also facilitated by decentralization, which granted substantial autonomy in debt financing to subnational governments but failed to impose hard budget constraints. In Zimbabwe, for example, poorly regulated subnational borrowing resulted in accumulated liabilities for the central government and significant financial losses for investors (White and Glasser 2004). Unregulated borrowing is particularly risky in an uncertain macroeconomic environment, as illustrated by the subnational debt crises in Russia.

The fiscal deficit itself may not be a problem if borrowing finances capital investment and economic growth, but borrowing to finance operating deficits leads to an unsustainable debt path. A major cause of subnational debt crisis in Hungary, India, Russia, and other countries was the use of borrowing to finance operating deficits. In India much of the growth in fiscal deficits of states in the late 1990s was driven by borrowing to finance revenue deficits. At the height of the crisis, for example, in some states more than 70 percent of new borrowing was used to refinance existing debt.

Furthermore, like national debt profiles, subnational debt profiles can experience rollover risks, which are exacerbated by macroeconomic and financial shocks. Before the macroeconomic crisis in Mexico in the mid-1990s and in Russia in the late 1990s, for example, subnational governments there had risky debt profiles—short maturities, high debt-service ratios, and variable interest rates. The macroeconomic crisis exposed the vulnerability of the subnational governments’ fiscal positions and triggered widespread subnational debt crises.

Finally, several sources of implicit borrowing by subnational governments can contribute to the deterioration of fiscal position and insolvency. Subnational governments can circumvent borrowing limitations imposed by the national government through a variety of channels, such as establishing off-budget companies; providing guarantees to the borrowing of public enterprises that do not have the credit strength to borrow on their own; establishing public-private partnership arrangements; borrowing from pension funds; and accumulating arrears to wages, pension payments, and suppliers. Among Indian states in the late 1990s, special-purpose vehicles became a convenient way of circumventing tight budgets. Guarantees by states to support market borrowing of loss-making public sector undertakings, a contingent liability, grew rapidly.

All major international rating agencies include the borrowing of subnational quasi-fiscal entities as part of subnational government debt profile. They include subnational debt from all public sector enterprises and other implicit and contingent obligations, such as public-private partnerships; bailouts of private companies; off-balance-sheet project financing; lease obligations; debt guarantees; and equity interests and liabilities in utilities, businesses, and banks.
Rationale for Regulatory Frameworks and Debt Management

The development of regulatory frameworks for subnational borrowing in middle-income countries since the late 1990s is the direct result of, and response to, subnational fiscal stress and debt crises. Some middle-income countries, such as Peru, developed regulatory frameworks for subnational borrowing at the beginning of the decentralization process, in order to preempt systemic subnational debt crises. Benefiting from middle-income countries’ reform experience, low-income countries should consider policy options before opening up a subnational debt market.

Regulatory frameworks for subnational borrowing should contain two parts: (a) ex ante control, regulation of borrowing, and monitoring of the subnational fiscal position and (b) ex post debt restructuring (to be used if 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. Regulatory frameworks are inseparable from the reform of intergovernmental fiscal systems and financial markets, because they profoundly shape incentives for subnational governments to pursue sustainable fiscal and debt policies and for creditors to price returns and risks appropriately.

Legislation on subnational borrowing functions as a commitment device that allows subnational governments to access the financial market within a common framework. Inherent incentives exist for a subnational government to free-ride, because it bears only part of the cost and all of the benefits of unsustainable fiscal policies. Realizing these benefits depends on good fiscal behavior by most of the other subnational governments. For this reason, governments benefit collectively from a system of rules to discourage such defection and free-riding. The commitment device controls and coordinates subnational governments across space in various localities and across time to commit future governments to a common borrowing framework (Webb 2004).

Ex ante regulations are unlikely to foster commitment in the absence of an ex post insolvency mechanism. A well-designed insolvency mechanism helps enforce the commitment device and hard budget constraints on subnational governments. Pressures for ad hoc political intervention decrease as restructurings become more institutionalized. Equally important, insolvency procedures help an insolvent subnational government maintain essential services while restructuring its debts. Because 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 financial market. Insolvency proceedings need to balance the interests of creditors and the debtor.
Together with triggering events, each country’s political, economic, legal, and historical context motivate it to develop a regulatory framework. These differences affect the entry point for reform, the framework’s design, and the framework’s relation to subnational borrowing legislation.

For example, the U.S. municipal bankruptcy framework has influenced the design of insolvency proceedings in some middle-income countries, but it cannot be copied by low-income or other middle-income countries without care. Chapter 9 of the U.S. bankruptcy code was conceived with the narrow objective of resolving the holdout problem, against the background of a mature intergovernmental fiscal system and a market-oriented financial system. In developing countries, development of a subnational insolvency mechanism must be sequenced with other reforms, and it must reflect the country’s institutional capacity. The unique federal structure of the United States also profoundly affected the design of Chapter 9 (with respect to the role of federal courts in the debt adjustment plan of insolvent municipalities, for example). Because a country’s subnational insolvency mechanism must define the respective role of different branches and tiers of government, the political and economic history of a country plays a key role in shaping the design of an insolvency system.

Frameworks for Subnational Borrowing

The two basic parts of regulatory frameworks—ex ante control and ex post debt restructuring in the event that subnational governments become insolvent—are closely related. By increasing the pain of circumventing ex ante regulation for lenders and subnational borrowers, insolvency mechanisms enhance the effectiveness of preventive rules.

Ex Ante Regulation. Ex ante regulation deals with the control of borrowing and the monitoring of the subnational fiscal position. Widespread subnational debt crises in the 1990s in countries such as Brazil and Mexico and prevalent subnational fiscal stress in countries such as Colombia and India motivated these countries to develop or strengthen ex ante regulation to help prevent future systemic stress and crises. In countries such as Peru, where decentralization has recently started, the government has emphasized the importance of fiscal sustainability and the need to reduce the risks of decentralization.

Several middle-income countries have developed ex ante fiscal rules for subnational governments. Brazil’s Fiscal Responsibility Law (2000), which applies to all levels of government, consolidated various pieces of legislation passed since 1997 into one unifying framework. Colombia’s Fiscal Transparency and Responsibility Law (2003) consolidated legislation passed since 1997. India’s 12th Finance Commission put forward recommendations on fiscal rules and provided incentives for states to...
comply with them. Mexico’s new borrowing framework was developed in response to the subnational debt crisis triggered by the financial crisis of the mid-1990s. Peru developed a subnational borrowing framework from 2003 to 2005 while embarking on decentralization, in order to avoid the mistakes of unregulated subnational borrowing while decentralizing.

These countries’ ex ante regulation shares several common elements that low-income countries may want to consider (Liu and Waibel 2008a). First, borrowing is allowed only for long-term public capital investments (the “golden rule”). (Short-term borrowing for working capital is allowed, but provisions should be built in to prevent governments from using rollover borrowing to cover operating deficits.) Middle-income countries including Brazil, Colombia, India, Peru, Russia, and South Africa have recently adopted this rule.

Second, the frameworks specify limits on key fiscal variables, such as fiscal deficit, primary deficit, debt-service ratios, and ceilings on guarantees issued. In Brazil, the debt-restructuring agreements between the federal government and the states established a comprehensive list of fiscal targets—debt-to-revenue ratio, primary balance, personnel spending as share of total spending, own-source revenue growth, and investment ceilings—as well as a list of state-owned enterprises or banks to be privatized or concessioned.

Colombia sought to limit subnational debt to payment capacity (through Law 358 in 1997 and the Fiscal Transparency and Responsibility Law in 2003). A traffic-light system was established to regulate subnational borrowing. Subnational governments rated in the red-light zone are prohibited from borrowing; those in the green-light zone are permitted to borrow. A state in the red-light zone is defined as one in which the ratio of interest to operational savings exceeds 40 percent and the ratio of debt stock over current revenues exceeds 80 percent.

In India, a state with a debt-service ratio exceeding 20 percent of revenues is classified as having debt-stress status, triggering the central government’s close monitoring of additional borrowing by the state. Following the recommendations of the 12th Finance Commission and responding to incentives of greater resource flows, all states have enacted fiscal responsibility legislation. These laws include commitments to eliminate revenue deficits and a time path for reducing the fiscal deficit to 3 percent of gross state domestic product.

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 requirement is intended to ensure that fiscal accounts move within a sustainable debt path and that fiscal adjustment takes a medium-term approach, in order to better respond to shocks and differing trajectories for key macroeconomic variables that affect subnational finance. The transparent budgetary process facilitates debates by executive and legislative
branches on spending priorities, funding sources, and required fiscal adjustments. Peru’s Fiscal Decentralization Law (2004) requires regional and local governments to prepare detailed multiyear budgetary frameworks that are consistent with the national government’s multiyear budget framework.

Fiscal transparency is increasingly becoming an integrated part of fiscal frameworks. Transparency includes having an independent audit of subnational financial accounts, making periodic public disclosures of key fiscal data, exposing hidden liabilities, and moving off-budget liabilities on budget. In Brazil, the accrual accounting method for all levels of government eliminates an important source of hidden liabilities: arrears. Article 48 of Brazil’s Fiscal Responsibility Law (2000) enshrines fiscal transparency as a key component of the new framework. Proposals, laws, and accounts are to be widely distributed, including through the use of electronic media (all reports are made available on the Web site of the Ministry of the Treasury). Article 54 requires that all levels of governments publish a quarterly fiscal management report that contains the major fiscal variables and indicates compliance (or lack of compliance) with fiscal targets. This report must be certified by the audit courts. In India, several reforming states have started to move off-budget liabilities onto the budget and have established a measure of consolidated fiscal deficit beyond the conventional cash deficit; the reported fiscal deficit does not capture the financing deficit of large public sector undertakings, which implicitly are states’ liabilities.

Ex ante regulation need not be purely on the borrower side. In Colombia, the Fiscal Transparency and Responsibility Law (2003) tightened the regulations on the supply side. 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. If they do not, the credit contract is invalid and borrowed funds must be restituted promptly, without interest or any other charges. To improve fiscal transparency in Mexico, policy makers there introduced a credit rating system for subnational governments. Although subnational participation in the credit rating is voluntary, the requirements of the capital-risk weighting of bank loans (introduced in 2000) and of loss provisions (introduced in 2004) aim at imposing subnational fiscal discipline through the market pricing of subnational credit.

Ex Post Insolvency Mechanisms. Ex ante regulation reduces the risk of defaults, but it cannot prevent all defaults. Ex post regulations—that is, subnational insolvency mechanisms—deal with insolvent subnational governments. Defaults may arise from a subnational’s fiscal mismanagement or from macroeconomic or exogenous shocks.

Several design considerations arise concerning insolvency procedures. They include the 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 interests of creditors and the insolvent subnational borrower.

The public nature of the services provided by governments explains the fundamental difference between public insolvency and the bankruptcy of a private corporation. This difference leads to the basic tension between protecting creditors’ rights and maintaining essential public services. Creditors’ remedies against defaulting subnationals are narrower than the remedies they can take against defaulting corporations, leading to greater moral hazard (strategic defaults). Whereas a corporation is able to self-dissolve, this route is barred for subnational governments. When a private corporation goes bankrupt, all of its assets are potentially subject to attachment. By contrast, the ability of creditors to attach the assets of subnational governments is greatly restrained in many countries. In the case of subnational insolvency, the insolvency mechanism is generally reorganization, not liquidation of all assets.

Mechanisms for resolving subnational financial distress are either administrative or judicial in nature, although various hybrids also exist. The choice depends on several factors. In administrative interventions, a higher level of government temporarily takes over financial management of the subnational entity. Provided the courts are independent, the judicial approach can reduce political interference during the restructuring and thus provide greater assurances to creditors. When Hungary introduced a subnational insolvency framework in 1996, it chose a judicial system for this reason. It thereby insulated the procedure from strong political pressure to bail out subnational governments, increasing the credibility of its no-bailout policy.

The power and legitimacy of the courts to render decisions with respect to expenditures and revenues is limited, however; leaving a wide margin of discretion to elected officials is critical. In the United States, judicial and administrative approaches coexist. At the federal level, Chapter 9 provides procedural machinery under which a debt-restructuring plan acceptable to a majority of creditors can become binding on a dissenting minority. This procedure grants substantial leeway to the debtor in terms of policy choices and budget priorities. However, states need to consent to their municipalities filing for Chapter 9. Several states employ additional administrative procedures for resolving municipal financial distress.

Key elements of subnational insolvency procedures include defining when a subnational entity is insolvent, undertaking fiscal adjustment to close the gap between expenditures and revenues, and restructuring debt to bridge any remaining shortfall in payment capacity. Fiscal adjustment and consolidation are preconditions for financial workouts. Often a subnational government’s own fiscal mismanagement is the root cause of insolvency. Even when subnational insolvency is triggered by macroeconomic shocks, such as a sharp rise in real interest rates through a currency crisis, fiscal adjustment is inherent to any insolvency procedure.
The maturity of the legal system influences the choice of procedure. Implementation of insolvency procedures—in the corporate and subnational contexts—rests on the shoulders of insolvency experts and on institutions (courts) that resist political influence and corruption. In many developing countries (both middle- and low-income countries), limited judicial and administrative capacity may be a binding constraint. The first step should be to develop institutional ingredients and train bankruptcy professionals. In countries in which the judicial system is embryonic, formal procedural guidelines can be a stepping stone to a fully developed mechanism. This interim solution can be used to build institutional and professional capacity in substantive restructuring (Gitlin and Watkins 1999).

Framework for Subnational Debt Management

In addition to the broad regulatory framework for subnational borrowing and insolvency, subnational debt management is essential to prudent fiscal and debt management, thereby reducing the probability of default. Subnational insolvency can result from any of the following factors: mismanagement of a subnational’s fiscal accounts, such as a mismatch between borrowing and debt-service capacity; macroeconomic or exogenous shocks; and a risky profile of debt composition, such as one that includes short maturity, currency risks, and variable interest rates.

Strategy for Managing Subnational Debt

Like national debt management, subnational debt management is the process of establishing and implementing a strategy for prudently managing the entity’s debt to meet its financing needs in a way that meets its risk objectives and any other goals it may have set. The stock of debt, and new borrowings arising from budget and off-budget sources, should be managed in a manner that is consistent with the subnational government’s cost and risk preferences. Doing so entails using the following four-pillar framework, based on the World Bank’s Debt Management Performance Assessment Tool (World Bank 2007) and cross-country experiences drawn from countries such as Brazil and Colombia:

- Governance and strategy development. A sound governance framework refers to the legal and managerial structure that directs the operations of government debt managers. It includes legislation that defines goals and accountabilities; embodies the management framework; and covers the formulation and implementation of strategy, operational procedures, quality assurance practices, and reporting responsibilities (Wheeler 2004). The strategy outlines the path by which the subnational’s debt-management objectives are
operationalized in the medium term. Under this pillar, the subnational government establishes clear debt-management objectives that are supported by a sound governance framework, a prudent cost–risk management strategy, an efficient organizational structure, appropriate management information systems, and a strong in-house risk management culture.

- **Coordination of borrowing with macro policies.** Coordinating borrowing with macro policies helps ensure that all portfolio-related transactions are consistent with the government’s fiscal and debt-sustainability strategy and are executed in an effective manner. Fiscal sustainability implies the government’s ability to maintain a certain set of fiscal and central government monetary policies without becoming insolvent. It also means that a government’s intertemporal budget constraint holds without explicit default on its debt. For policy purposes, it is useful to disentangle the growth and inflation effects on indebtedness as shown in equation (14.1):

\[
b_t - b_{t-1} = i_t - x_t - \frac{g_t}{(1 + g_t)(1 + \pi_t)} b_{t-1} - \frac{\pi_t}{(1 + \pi_t)} b_{t-1},
\]

where \(b_t, i_t,\) and \(x_t\) are the outstanding public state debt, interest payments, and primary balance, respectively, as shares of gross subnational domestic product in period \(t; g_t\) is the real annual growth rate; and \(\pi_t\) is the annual inflation rate. Under different scenarios, debt sustainability is assessed using

\[
b_t = \frac{(1 + r_t)}{(1 + g_t)} b_{t-1} - x_t,
\]

where \(r_t\) is the real interest rate, defined as \(r_t = [(n_t + 1)/(\pi_t + 1)] - 1.

- **Borrowing and related activities.** Well-developed local capital markets are important because they provide stable funding sources in domestic currency for subnationals and allow liabilities to be more closely matched to the revenues that will service them. Well-developed domestic markets also enhance the efficiency and stability of financial intermediation, provide a broader range of assets, and facilitate better risk management. To the extent possible, debt issuance by subnationals should use market-based mechanisms (including competitive auctions) and syndications. Engaging in domestic borrowing activities that are transparent and predictable will provide the government with a mechanism with which to finance its expenditures in a cost-effective manner while minimizing risks. All borrowing activities should be in accordance with the government’s debt strategy (World Bank 2008b).

- **Evaluation, debt recording, and reporting.** Sound practice requires comprehensive debt management systems to record, monitor, settle, and account effectively for all subnational government debt and debt-related transactions. The subnational government should report total debt outstanding to foster transparency and accountability.
Cross-country experiences show that subnational entities range from those that are “regulated and monitored” by the federal government (for example, Brazil and Colombia) to those in which subnational entities have more autonomy (for example, Canada and the United States) in meeting their borrowing requirements. The degree of independence from the center affects how regulatory oversight and compliance with budgetary rules are enforced, which in turn determines the regulatory and debt-management frameworks that can be applied in such countries. Any strategy for subnational debt management must be mindful of different channels of subnational borrowing (box 14.1).

Box 14.1 Autonomy and Regulation in Issuing Subnational Debt in India

An important factor affecting subnational regulation and debt management is the degree and extent to which the federal government monitors and controls such debt. Variants range from onlending by the federal government to accessing of debt through wholesale markets or by issuance of retail debt at fixed rates of interest. The federal government (or the center) exercises control by determining either the quantity of borrowings the subnational can assume or the rate at which it can borrow (in extreme cases, it determines both). The debt-management arrangements and the regulatory frameworks are then determined by the degree of operational independence the subnational exercises in sourcing its financing requirements.

In India, 40 percent of state government debt is wholesale debt for which the central government determines the level of debt to be contracted in a year. Wholesale debt (loans from banks and financial institutions, loans from the domestic market, and external loans from multilateral development agencies) is monitored and regulated by the center, which derives this power from Article 293 of India’s constitution. Article 293 mandates that if a state government is indebted to the central government, it requires the consent of the central government to raise loans or offer guarantees.

A large component of total debt (more than 60 percent) is retail debt, which has an exogenous accumulation mechanism and thus lies outside the regulatory ambit of the federal government. This debt, which is at above-market rates, results in higher costs to the subnational governments, dilutes overall fiscal discipline, compromises budgetary constraints, and could result in building unsustainable debts. Retail debt is contracted through public accounts and small saving instruments. In 2007, India’s 12th Finance Commission recommended reforming this system. Reforms would strengthen subnational fiscal discipline.

Differences between National and Subnational Debt Management

Although the dynamics of national and subnational debt are similar, critical differences exist. A debt-management strategy for subnational governments must be developed in the context of these differences.

One important difference is the inability of subnational governments to issue their own currency. Seigniorage plays no role in subnational government finance. Just as in a Ricardian regime, the state government’s lifetime budget constraint suggests that for debt to be sustainable, the outstanding stock of debt should not exceed the present value of all current and future primary surpluses:

\[
B_{-1} = \sum_{t=0}^{\infty} D_{0t} X_t, \tag{14.3}
\]

where \( B_{-1} \) is the stock of initial total public debt of the state and \( D_{0t} = (1 + n_0)^{-1} \ldots (1 + n_t)^{-1} \).

The present value approach incorporates creditors’ incentives in determining the financing options facing the government. Under this approach, creditors lend to the government only if they consider government policies sustainable. As long as credit risk plays a role in the subnational financing system, additional borrowing will dry up if policies are perceived as unsustainable; only by reducing debt or adjusting the policy stance (that is, by ensuring that past and current primary deficits imply future primary surpluses in present value terms) will the government be able to borrow again.

Because monetary policy is under the purview of the central government in almost all countries, the nominal interest rate is arguably outside the influence of a single subnational government, as long as the subnational entity is small. Although the subnational government cannot set the interest rate at which it borrows (at least not in a competitive bond market), the spread it pays over the central government’s rate is presumably linked to its own creditworthiness.

Another key difference between subnational and national debt is that foreign exchange risk may not directly affect subnational finance. In China, Kazakhstan, Peru, and Vietnam, for example, subnational governments are prohibited from external borrowing, and all external borrowing needs approval and guarantee from the national government. In cases in which subnational entities are allowed to borrow in foreign currency, the analysis of such risks is important, as illustrated by the debt crises in Brazil in 1990 and Russia in 1998. Even if subnationals are prohibited from borrowing externally, currency risks can indirectly affect their sustainability through real interest rate shocks, as they did in Mexico in 1994–95.

Legal constraints set by the constitutions and laws of subnational governments limit their ability to raise their own revenue, a key determinant of...
the primary balance. For example, there are no subnational taxes in Vietnam, where the central government controls tax bases and rates and the Department of Tax Administration collects all nontrade revenues (World Bank 2007). In India, the constitution limits the power of states in setting tax policy for major categories of taxation. In countries in which the legal framework for fiscal decentralization is still evolving, the ability of subnational governments to raise their own revenue can change over time. For example, whereas before 2005 Chinese provinces levied and retained personal income tax, personal income tax is now shared equally by China’s central government and the provinces.43

Transfers from the central government (or higher levels of government in multitier structures) are an important source of subnational revenues, although the dependency of subnational governments on fiscal transfers varies significantly across countries. On average, fiscal transfers represent just under 40 percent of states’ revenues in India (World Bank 2005a), 50 percent in Ethiopia except for Addis Ababa (World Bank 2008a), 85–95 percent in Mexico (Webb 2004), and 85 percent in Uganda (Mayanja and Mayengo 2007).

The predictability of transfers—an important consideration in a fiscal-sustainability analysis—depends on how the transfer system is set up. India and Vietnam use a formula-based approach that enhances transparency and fosters predictability.44 Nigeria’s constitution provides that all revenues collected by the federal government be paid into one distributable pool, called the Federation Account.45

The central government affects the fiscal balance and the growth prospects of the subnational economy in other ways as well. In some countries (such as Brazil, Cambodia, India, Thailand, and Vietnam),46 the center sets or influences policy on wages and pensions. In others (such as Colombia, Indonesia, Mexico, Peru, Russia, and Thailand), it establishes ceilings on debt services and debt stock. In countries such as Nigeria, Uganda, and Vietnam, the center has set ceilings on subnational debt service.

Expected bailouts by the central government affect subnational debt dynamics. 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 the subnational government. This situation was apparent in the early 2000s, as evidenced by the market subscription for even highly stressed states in India. Central governments’ guarantees for local government bailouts were perceived to be contributing factors for widespread subnational debt stress in Mexico in the mid-1990s and Russia in the late 1990s. Bailouts in Bolivia over the years did not provide an adequate environment for proper subnational debt controls (IMF 2006). The problem of moral hazard is often compounded by lack of market transparency, weak market governance, distortions in the competitive framework among market participants, and inadequate capacity for financial management by subnational entities.
In addition to the differences outlined above (Ianchovichina, Liu, and Nagarajan 2007), debt management at the subnational level can also be affected by the lack of adequate liquidity and the fragmentation of issuances at the subnational level. If supported by an implicit sovereign guarantee, debt issuance at the subnational level implies multiple issuers of securities, with varying claims to sovereign creditworthiness that fragment the market. This is reflected in poor secondary market trading of subnational bonds. In Nigeria, one or two state governments access the domestic markets, creating pools of illiquid paper that is neither traded nor fungible, most of it held to maturity. This type of debt does not contribute to the development of a domestic debt market. Moreover, the multiplicity of subnational issues in a bond market that is still relatively underdeveloped can make the establishment of national benchmarks difficult (World Bank and IMF 2001).

Subnational governments must also overcome adverse perceptions of their debt-related activities. Historically, most subnationals have confronted hard budget constraints set by the central government by either allocating the ceiling amount of borrowings or fixing the rates of interest. Over time, such budget constraints can loosen as a result of subnationals accessing borrowing outside the central allocations and off-budget measures and special-purpose vehicles. The perception of states’ credibility and creditworthiness is determined largely by the budgetary position of their parastatals. Debt management at the subnational level is largely constrained by these characteristics. To gain market acceptance and overcome such shortcomings, subnational governments must impose greater transparency and market-governance mechanisms.

These differences call for greater intergovernmental coordination and policy dialogue about reform. Both national and subnational governments in a range of countries have been experimenting with and strengthening their strategies and capacity in implementing the four-pillar debt management framework outlined above. Brazil and Colombia closely monitor their subnational debt profile through a series of indicators. Several states in India focused on the first pillar for governance by enacting fiscal responsibility legislations. Mexico introduced a credit rating system for subnational governments. Although subnational participation in the credit rating is voluntary, the requirements of the capital risk weighting of bank loans (introduced in 2000) and of loss provisions (introduced in 2004) aim to impose subnational fiscal discipline through the market pricing of subnational credit.

Conclusion

Subnational debt management is emerging as an important public policy agenda for low-income countries. Coupled with decentralization, the changing financial landscape presents both opportunities and challenges for subnational governments in low-income countries in transition to
market access. Experience from middle-income countries 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 it also suggests that unregulated borrowing by subnational entities creates substantial fiscal risk, 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. Middle-income countries’ experience also shows that risks are high during the initial stage of fiscal decentralization, the stage in which some low-income countries now find themselves.

These risks are exacerbated if decentralization is accompanied by episodes of macroeconomic instability and unregulated financial markets. The ongoing global financial crisis is putting stress on macroeconomic frameworks and reducing growth prospects in all countries. The structural trend in fiscal decentralization in the midst of macroeconomic uncertainty requires more care in managing subnational borrowing. As middle-income countries’ experience in the 1990s shows, decentralization and rapid development of subnational borrowing in the midst of macroeconomic uncertainty can be hazardous.

Although the dynamics of national and subnational debt are similar, critical differences exist. A regulatory framework for subnational borrowing and debt management must be developed in the context of these differences.

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. Bailouts of insolvent subnational governments can undermine the effectiveness of subnational borrowing regulations. Worse, banks may act as implicit agents of the nation by lending to uncreditworthy subnationals with the expectation of bailouts in case of trouble.

For middle- and low-income countries, a well-designed regulatory framework for all subnational borrowing helps preempt soft-budget constraints, strengthens fiscal discipline, better aligns incentives of both borrowers and creditors, supports broader intergovernmental fiscal reforms, and encourages the efficient use of capital. By hardening the budget constraint for fiscal irresponsibility, such regulation helps subnational governments fulfill their broader public responsibilities as self-standing borrowers.

The pace of developing a subnational borrowing framework varies across countries, depending on a country’s historical, political, and economic conditions and its entry point for reforms. Other countries’ experience cannot be copied without care. An active subnational debt-management strategy highlighting cost-risk trade-offs complements 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 sub-
national level carrying an implicit sovereign guarantee implies multiple issu-
ers of securities with varying claims to sovereign creditworthiness, which
may fragment the market and reduce its liquidity and efficiency.

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

Increasing (or introducing) transparency should be a policy priority. Off-
budget liabilities present tremendous fiscal risks. As part of ex ante regulations,
subnational governments in middle-income countries are increasingly
required to develop a medium-term fiscal framework, improve fiscal trans-
parency, and strengthen the timely availability and independent audit of
fiscal accounts, including implicit and contingent liabilities.

In this rich policy agenda, many topics remain to be explored further.
In many low-income countries, for example, onlending from the central
government to subnational governments is likely to continue. What are
the pros and cons of such activities? What policy frameworks should gov-
ern them? How can investors measure the extent of off-budget liabilities
associated with quasi-fiscal entities in low-income countries? All of these
topics merit further research.

Notes

1. The subnational level of government is defined as the level of government
below the central or federal government. Based on the World Bank’s July 2008
classification, there are 49 low-income countries, defined as countries with aver-
age gross national income (GNI) per capita (calculated using the World Bank Atlas
method) of $935 or less. Middle-income countries are divided into two groups:
lower-middle-income ($936–$3,705) and upper-middle-income ($3,706–$11,455)
countries.

2. For the purpose of this chapter, market-access countries are defined as the
subset of low- and middle-income economies in which a significant share of debt is
issued purely on market terms (for example, nonconcessional commercial debt).

3. According to the World Bank’s classification, the term developing economy/coun-
country includes low- and middle-income economies.

4. This chapter focuses on a subset of issues concerning subnational borrow-
ing regulations and debt management. Broader reforms, such as reform of the
intergovernmental fiscal system and the development of government security mar-
ket, are beyond the chapter’s scope. The chapter focuses on the subset of countries
that are already decentralizing and exploring subnational government access to
financial markets.
5. Launched by the World Bank and the International Monetary Fund (IMF) in 1996, the HIPC Initiative provides debt relief to low-income countries in which the ratio of the net present value of debt to exports exceeds 150 percent or the ratio of the net present value of debt to fiscal revenue exceeds 250 percent. The MDRI provides 100 percent relief to low-income countries on eligible debt from four multilateral institutions: the IMF, the International Development Association of the World Bank, the African Development Fund, and the Inter-American Development Fund.


7. Countries face two options: onlending funds from the central government to subnational governments or allowing subnationals access to the financial market. The pros and cons of each option relate to the stage of development of their financial markets, the capacity of subnational governments in fiscal and debt management, and the political dimension of decentralization. The focus here is on the conditions that must be established before allowing some creditworthy subnationals access to financial markets.

8. For a more detailed discussion of the reasons behind decentralization in Bolivia, Brazil, China, India, Indonesia, South Africa, and Uganda, see Bardhan and Mukherjee (2006).

9. The study measured the degree of political decentralization by the number of directly elected (versus appointed) levels of local governments and the degree of fairness and freedom of such elections.

10. The study measured administrative decentralization by the clarity of functional assignments and the use of the subsidiarity principle in their distribution across levels of government. It measured fiscal decentralization by the existence of rules for intergovernmental transfers and the level of public expenditures that was under subnational governments’ control (at least 5–10 percent).

11. During the second half of the 1990s, the government of Ethiopia, together with development partners, conducted a number of studies to identify the factors that hindered public sector efficiency and accountability (see, for example, World Bank 2008a). These studies reveal that local governments had limited fiscal or administrative autonomy with which to respond to the needs of their constituencies. Findings in other low-income countries, such as Pakistan (World Bank 2004) and those in East Asia (World Bank 2007), are similar.

12. Constructing a comprehensive data set on subnational finance is challenging given the lack of good-quality data at the subnational level in many developing countries and the different ways in which countries classify their subnational expenditure items.

13. In 2005, 63.9 percent of public capital expenditure in Europe was made by local and regional governments. Between 2000 and 2005, local and regional investment rose more rapidly than GDP (Dexia 2006).

14. The national government contributes 88 percent of annual infrastructure investments in Pakistan and 84 percent in Bangladesh, for example (Kim 2003; Asian Development Bank 2007).

15. In 2007, states accounted for 41.8 percent of Nigeria’s total external public debt. The federal government guarantees all external debts of states. Over the years, states have amassed large formal and informal debts, including bank loans, credits and long-term debts, pension and salary arrears, and debts to contractors (see DFID 2007).

16. According to the Budget Law (2002), the stock of outstanding subnational debt cannot exceed 30 percent of capital budget in a given budget year.
17. China, for example, has been investing about 10 percent of its GDP annually in infrastructure since the 1990s, with subnational governments accounting for a large share of these investments, particularly in urban infrastructure. The majority of financing comes from proceeds from land leasing and public bank lending securitized on property and land valuation. In contrast, public infrastructure investment by Indian states has remained below 3 percent of their gross state domestic product since the 1990s (Liu 2008). In the United States, subnational infrastructure is financed predominantly by bonds raised in the private capital market.

18. Borrowing to finance infrastructure that is badly planned and managed can burden future generations with debt without yielding corresponding benefits.

19. In establishing a framework for municipal finance borrowing after the fall of apartheid, South Africa clearly understood the benefits of competition in the subnational credit market. Its Intergovernmental Fiscal Review report states, “Active capital markets, with a variety of buyers and sellers, and a variety of financial products, can offer more efficiency than direct lending. First, competition for municipal debt instruments tends to keep borrowing costs down and create structural options for every need. Second, an active market implies liquidity for an investor who may wish to sell. Liquidity reduces risk, increases the pool of potential investors, and thus improves efficiency” (South Africa National Treasury 2001, p. 192).

20. The economics literature approaches insolvency from the perspective of the sustainability of fiscal policies. In a number of countries, specific legal definitions serve as procedural triggers for initiating insolvency procedures. In a legal sense, subnational insolvency refers to the inability to pay debts as they fall due. Details vary across countries (see Liu and Waibel 2008b).

21. For China, see Liu (2008); for India, see Ianchovichina, Liu, and Nagarajan (2007).

22. See Weingast (2007) for a summary of the literature within the context of second-generation fiscal federalism.

23. This is a generic concern, irrespective of whether the borrower is a subnational entity. It can be greater, however, if the borrower is a subnational entity and its system of financial management and reporting is not transparent.

24. Such finance can take multiple forms, including direct borrowing and the running of arrears.

25. This statement assumes that economic growth translates into increased capacity to service debt. This may not happen if a subnational government is unable to exploit its growing tax base. In this case, borrowing can provoke a fiscal crisis even if the proceeds have been put to good use.


27. A revenue deficit is the amount of current expenditure (such as wages, pension outlays, subsidies, transfers, and operation and maintenance) net of total revenues. For a discussion of the state fiscal crisis in India, see Ianchovichina, Liu, and Nagarajan (2007).

28. From 1998 to 2001, at least 57 of 89 regional governments in Russia defaulted (Popov 2002). In 2001, six years after the peso crisis, 60 percent of subnational governments in Mexico still struggled financially (Schwarcz 2002). One interesting difference is that subnational governments were allowed to borrow overseas in Russia, whereas such borrowing was prohibited in Mexico. Subnational governments in Mexico were not insulated from foreign exchange risks, however, because the risks were transmitted through inflation and interest rates.

29. For a review of subnational credit rating methodologies by major rating agencies, see Liu and Tan (2009).
30. See Ter-Minassian and Craig (1997) for a summary of subnational borrowing control frameworks in more than 50 countries and Liu and Waibel (2008a) for a review of ex ante regulations since the late 1990s in several countries. For comparative experiences of ex post insolvency mechanisms, see Liu and Waibel (2008b).

31. Insolvency mechanisms could be in the form of an administrative type of debt restructuring without a formal bankruptcy law.

32. If a bailout system exists, subnational governments are likely to share the national rating assigned by rating agencies. The subnational governments might thereby have easier and cheaper access to the capital market.

33. Chapter 11, the U.S. bankruptcy law for corporations, has significantly affected other countries. Chapter 9 of the Bankruptcy Code has strongly influenced subnational insolvency frameworks in countries such as Hungary and South Africa.

34. The constitutionally mandated Finance Commission convenes every five years to determine the sharing of revenues between the center and the states. Depending on its terms of reference, it may also recommend measures to improve state finances.

35. Brazil’s fiscal responsibility legislation tightly controls current expenditure and aims for a positive primary balance. Colombia’s Fiscal Transparency and Responsibility Law (2003) mandates that the primary surplus must exceed debt service. India’s 12th Finance Commission mandates that states eliminate revenue deficits (current expenditure exceeding total revenue), which implies that borrowing should be used to finance capital expenditure only. Under Article 24 of Peru’s Fiscal Decentralization Law (2004) and Article 51 of its General Debt Law (2005), borrowing can be used solely to finance infrastructure projects. According to the Russian Budget Code (1998), current expenditure by regional governments may not exceed total revenues, and their borrowing may be used only to finance investment expenditures. The South African constitution prohibits borrowing for consumption expenditure (South Africa National Treasury 2001).

36. The rating system established under Law 358, passed in 1997, established indebtedness alert signals, based on a liquidity indicator (interest payment/operational savings) and a solvency indicator (debt/current revenue). Subnational governments were classified into one of three zones. Governments in the red-light zone were not allowed to borrow, governments in the green-light zone were allowed to borrow, and governments in the yellow-light zone were allowed to borrow with the permission of the central government. Law 795, passed in 2003, eliminated the yellow-light category. Law 617, passed in 2000, established a ceiling for the ratio of discretionary current expenditure to nonearmarked current revenues. The implementing rules for Law 819, passed in 2003, added a third indicator to the traffic-light system, by relating the primary surplus to debt service.

37. The debt-service ratio measures the capacity to service debt. Many national governments monitor the debt-service ratio of subnational entities, although they define payment capacity differently. Brazil’s Fiscal Responsibility Law defines it as the share of current revenue net of transfers. Colombia’s Law 358 of 1997 records it as the share of operational savings. India defines it as the ratio of debt-service payments over total revenues. In a 2003 law amending its Fiscal Prudence and Transparency Law, Peru treats it as the share of current income including transfers. Russia’s Budget Code denotes it as the share of total budgetary expenditures.

38. The boundary between ex ante regulation and ex post insolvency is not clear cut. Fiscal responsibility regulation, for example, may incorporate elements of ex post consequences. For example, India’s 12th Finance Commission mandates that states enact fiscal responsibility legislation and meet specific fiscal targets, such as eliminating the revenue deficit. The commission also provides incentives to states, such as swapping high-cost debt with lower-cost debt to meet fiscal targets.
Such incentives can be interpreted as ex post consequences. Webb (2004) includes transfer intercepts and lender control mechanisms as part of ex post consequences. The focus here is on the insolvency proceedings themselves.

39. For countries allowing subnational governments to access external financing, equation (14.2) must be amended to include the exchange-rate effect.

40. International practice has shown that sovereigns can benefit by providing market participants and investors with details of borrowing plans and other market activities well in advance and then acting consistently when issuing new treasury bonds or undertaking other activities. Doing so leads to lower costs by providing investors with greater certainty, increasing liquidity, broadening the investor base, and creating a level playing field for investors.

41. In a Ricardian regime, the government issues debt to cover deficits but never issues money.

42. In India, the 12th Finance Commission recommended that the center directly pass through all external borrowings to the states at the same terms (currency, maturity, and interest rates) it pays.


44. India’s constitutionally mandated Finance Commission convenes every five years to determine the sharing of revenues between the center and the states on the basis of a formula using weights, which could be changed, for relevant factors (such as population, income disparity, area, tax effort, and fiscal discipline). In Vietnam, intergovernmental transfers are distributed on the basis of formulas that remain unchanged for three to five years.

45. The Federation Account excludes personal income tax on members of the armed forces, police force, the Ministry of Foreign Affairs, and residents of the Federal Capital Territory.

46. Subnational governments in Cambodia, Thailand, and Vietnam prepare their own budgets, subject to certain central mandates and strict civil service regulations (World Bank 2007). This practice is now being phased out in Vietnam, allowing for greater subnational autonomy.

47. Brazil’s Fiscal Responsibility Law (2000) provides a framework for regulating and monitoring government fiscal and debt performance, including those of subnational governments. In Colombia, four entities manage Bogota’s public debt and risk. The Risk Policy Committee establishes guidelines and policies, and it defines and approves the operational guidelines for implementing risk-control strategies. The Office of Risk Control updates and monitors guidelines and methodologies for the control of the liability portfolio. The Directorate of Public Credit administers the debt portfolio, distributes the resources, and manages the risks. The debt-risk management guidelines spell out rules. The rule on liquidity specifies that maximum annual amortization should be 15 percent of total debt, with a deviation of up to 18 percent and a minimum average life of 4.15 years. The rules on foreign exchange and interest rates specify a maximum of 20 percent of debt with exposure to a foreign currency and a maximum of 70 percent in variable-rate instruments.

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