Does Decentralization Enhance Service Delivery and Poverty Reduction?

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13. Subnational insolvency and governance: cross-country experiences and lessons

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1 INTRODUCTION

The effectiveness of decentralization depends in part on the design and operation of subnational access to credit. Three factors have propelled the growth in subnational capital markets in developing countries since the 1990s and will continue to drive their future growth. First, decentralization in many developing countries has given subnational governments significant spending responsibilities, taxation power and the capacity to incur debt. Second, large infrastructure financing needs in developing countries are increasingly seeking capital market financing to match the intertemporal nature of infrastructure. Infrastructure networks benefit future generations as well; thus sound public policy demands that the financing of infrastructure networks be shared by future generations through matching repayment of debt financing with maturity of assets. Third, liquidity and growing mobility of international capital across national borders have lowered the cost of borrowing and thereby strengthened financing opportunities for infrastructure. Although the current financial crisis has strained the subnational credit market, the mobility of capital is likely to resume over the medium term.

This growth in subnational credit markets is characterized by two distinct features. First, subnational bonds have become an increasingly important source of funding due to diversification of financial instruments and increasing flow of international capital to developing countries. Second, although public institutions continue to dominate subnational lending in a number of countries such as Brazil and India, private capital has emerged to play an important role in subnational finance in countries such as Hungary, Mexico, Poland, Romania and South Africa and a dominant role in Russia.

Yet, growth in subnational bond markets in developing countries has
not been steady. Annual volume gradually increased from US$5.7 billion in 1992 to US$22.2 billion in 1995, to be followed by a general downward trend to US$3.5 billion in 2001. From 2001 until recently, growth in subnational bond markets picked up in emerging markets such as Russia, Mexico, Poland and Romania. However, the recent worldwide tightening of liquidity has significantly reduced private credit available to subnational entities.

Even at the peak of the subnational bond market growth in developing countries, the availability of credits to subnational governments remains limited to top-tier subnational governments. By developed country standards, the market was small even at its growth peak. In the United States, US$400 billion subnational bonds are issued per year on average. In contrast, 19 Mexican subnationals issued US$1.44 billion bonds over the period 2001–05. In Colombia, only the capital Bogota accessed the capital market from 2003–06.

Several opposing forces explain the still thin subnational bond markets in emerging economies. As highlighted by the World Development Report (World Bank, 2000), subnational debt is “one of the thorniest issues for decentralization, with many potential pitfalls”. These opposing forces range from incomplete decentralization, which limits a subnational’s own-revenue capacity, to a lack of transparency in fiscal accounts, which makes it difficult to evaluate subnational creditworthiness. Furthermore, several emerging economies have tightened subnational borrowing restrictions after experiencing subnational or national debt crises. Such tightening is part of broader ongoing efforts to develop a sound regulatory framework to tackle subnational insolvency.

Subnational insolvency is a reoccurring event in development. In 1842, eight US states and the Territory of Florida were in default on their debt and three other states were in perilous financial condition (Wallis, 2004). Similarly, during the Great Depression, 4770 local governments defaulted on US$2.85 billion of debt between 1929 and 1933, and by 1933 over 16 percent of the US municipal market was in default. As capital markets and their regulatory framework matured, defaults by US subnationals became less frequent. Yet crises continue to occur. Prominent examples include the fiscal crisis of New York City in 1975, the default on US$2.25 billion in bonds of the Washington Public Power Supply System in 1983 and the bankruptcy of Orange County in 1994 and the District of Columbia in 1995. There have also been many cases of local government financial distress in Japan and Western European and the Nordic Countries.

Several major emerging markets experienced subnational debt crises in the 1990s. Newly decentralized countries face similar risks. To many observers runaway provincial debt in the Provinces of Mendoza and
Buenos Aires was a major factor behind Argentina’s sovereign debt default in 2001. Brazil experienced three subnational debt crises in the 1980s and 1990s. In India, many states experienced fiscal stress in the late 1990s to the early 2000s, with a rapid increase in fiscal deficits, debt and contingent liabilities. The 1995 Tequila Crisis in Mexico exposed the vulnerability of subnational debt to the peso devaluation and led many Mexican subnationals into default. In Russia at least 57 out of 89 regional governments defaulted over 1998–2001.

The perils of subnational insolvency are serious. At a minimum, provision of local public goods and services may be severely impaired. When New York City was in fiscal crisis in 1975, essential services such as fire protection, police patrols and schools were cut back. Maintenance on bridges and roads was postponed. Many capital projects were delayed or cancelled.12 Beyond local service delivery, systemic subnational insolvency may impede the growth of subnational capital markets, curtail fiscal space for infrastructure financing and threaten macroeconomic and financial stability.

The ongoing global financial crisis has brought the nexus into sharper focus between borrowing constraints and the levels of public service delivery. States and municipalities in the United States are struggling financially and there are signs of stress threatening the fiscal sustainability of subnational governments in a growing number of developing countries. Slower economic growth and revenue shortfalls of national governments are likely to reduce fiscal transfers from the national government to subnational governments; and fiscal transfers account for a significant share of subnational finance in many developing countries. Service delivery is also likely to be impacted by shortfalls in subnational governments’ own-source revenues.13

Given the impact of subnational insolvency on service delivery and macroeconomic stability, many developing countries have been searching for systemic frameworks for subnational borrowing and insolvency (Liu and Waibel, 2005; Webb, 2005).14 Experience from developed economies suggests that ex ante subnational borrowing regulations need to be complemented by ex post mechanisms for insolvency resolution. More and more countries regard ex ante limits on subnational fiscal indicators (such as balanced budget rules, limits on the ratio of debt over gross subnational domestic product (GSDP) and debt service ratios) as insufficient.15 The effectiveness of ex ante regulation is limited without an ex post mechanism for subnational insolvency to deter irresponsible borrowers and imprudent lenders.

Several arguments favor ex post subnational insolvency mechanisms. First, insolvent subnationals are put back on a sustainable fiscal path
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to guarantee public service delivery. Second, restoring subnational sustain-
tability serves creditors collectively. Third, protecting creditor rights helps nurture embryonic capital markets. Fourth, clarity in default helps improve creditworthiness of subnational entities and enable subnational entities to re-enter the capital market for financing infrastructure. A well-designed workout procedure results in equitable debt collection for creditors, while lowering the costs of borrowing and creating fiscal space for infrastructure investment.

This chapter surveys mechanisms for the resolution of subnational financial insolvency in selected countries. It fleshes out basic concepts and highlights transferable features. Focusing on the experiences of Brazil, Bulgaria, Hungary, Romania, South Africa and the United States, we draw lessons for tailoring subnational insolvency mechanisms to country-specific circumstances. Although there are individual country case studies, the literature lacks a cross-country survey. This chapter seeks to fill this gap. Comparison across country experiences helps draw out core principles of subnational insolvency mechanisms and demonstrate how the application of these principles varies by a country’s unique context.

The chapter is structured as follows. The next section examines the events triggering the development of subnational insolvency mechanisms in various countries. This motivation is country-specific and shapes the design. We then explore the core principles of insolvency mechanisms, encapsulated in the trade-off between protecting creditors’ contractual rights and maintaining minimum public services. We next discuss the central elements of mechanisms: triggering, filing, collective enforcement, fiscal adjustment and debt restructuring. In the concluding section we draw policy lessons for other developing countries. In the Appendix we outline the main elements of subnational insolvency procedures in Hungary, South Africa and the United States.

2 WHY REGULATE SUBNATIONAL INSOLVENCY?

Sustaining healthy growth in subnational credit markets requires a transparent framework for allocating risks and losses in default. The first purpose of the framework is to credibly signal to lenders that debt restructurings or potential discharges will be predictable and equitable. The second aim is to maintain minimum essential public services such as law and order, fire protection and water and sanitation during a subnational government’s debt restructuring and fiscal adjustment.

While sharing these objectives, a country’s political, economic, legal and historical context in combination with unique triggers results in a country-
specific motivation. These differences affect the entry point for reform, the framework’s design and its relation to subnational borrowing legislation. Despite important differences, individual experiences are valuable to other countries as they consider their policy options. This section summarizes experiences in the United States, South Africa, Hungary, Brazil and four Central and Eastern European Countries.

2.1 United States

In response to widespread municipal defaults during the Great Depression, the US Congress adopted a municipal insolvency law in 1937. The primary aim of this legislation was to deal with the holdout problem. Individual creditors often demanded preferential treatment and threatened to derail debt restructurings voluntarily negotiated between a majority of creditors and the subnational debtor.

The enactment of the municipal bankruptcy statute in 1937 was one more step in a series of regulatory reforms on subnational borrowing since the first subnational debt crisis in the early 1840s. After the 1840s crisis, 12 states adopted new constitutions, and 11 of the 12 required that state legislatures adopt new procedures for authorizing state borrowing. Other reforms at the time included opening access for infrastructure finance and development and eliminating taxless finance.

Following the reform in the 1840s and 1850s, various states also reformed their municipal borrowing regulations. One important concern was debt service in the event of default. In theory, the main remedy was one without analogue in private bankruptcy; the issuance of a writ of mandamus imposing new taxes. The 1870 Illinois Constitution, for example, obliged the general assembly to tax all property within the limits of municipal corporations for debt payment. In theory, creditors could thus use the mandamus to compel municipal officers to service debt obligations; in practice, this remedy was largely ineffective.

The Great Depression, when subnational financial distress was prevalent, revealed the practical drawbacks of the mandamus. At the time, 4770 local governments defaulted on US$2.85 billion of debt. By 1933 over 16 percent of the US municipal market was in default. In such circumstances, raising taxes is not likely to produce more revenue, as high taxes often lead to the flight of higher-income taxpayers and businesses. During the Great Depression, taxes were already at historical highs. Mandamus is useful for enforcing unpaid discrete obligations; it is ineffective if the subnational is unable to pay. Moreover, courts often regarded the mandamus as discretionary, and when it was ordered, municipal officers took various actions to escape the mandamus. In extreme cases, they resigned.
As an individual creditor action, the mandamus cannot solve the collective action problem. When widespread defaults occur, individual creditor enforcement is impracticable, costly and potentially harmful to the interests of a majority of creditors. The inability to compel holdouts to cooperate in a negotiated compromise motivated the passage of Chapter 9 of the US Bankruptcy Code.21

Chapter 9 is not the only subnational insolvency mechanism in the United States. Many states have adopted their own frameworks for dealing with municipal financial distress, for two reasons. First, municipalities are political subdivisions of the states, thus they are creatures of the states. Second, state consent is a precondition for municipalities to file for Chapter 9 in federal court. There is no uniform approach across states. Twenty-one of the 50 states give blanket consent, three states attach important conditions and 27 states grant permission on a case by case basis.22

When New York City went into financial crisis in 1975, then the largest municipal fiscal crisis since the Great Depression, the state of New York intervened directly. The state took over the city’s financial management through the Municipal Assistance Corporation (MAC) in June 1975. MAC was a public benefit corporation of the state of New York to help the city restructure its glut of short-term debts.23 Three months later the state established the even more powerful Emergency Financial Control Board (EFCB) for New York City.24

The EFCB took over fiscal management of the city, imposed difficult fiscal adjustment measures, restructured debt, curtailed borrowing, oversaw the creation and execution of a three-year fiscal adjustment imposed on the city that would result in balanced budgets, increased taxes and fees, dismissed 60,000 public servants and enforced transparency in accounting, auditing and financial reporting.

As the EFCB was created by the state legislature, it had the legitimacy and broad authority to directly address the root cause of fiscal decline. Had New York City instead petitioned for bankruptcy protection under Chapter 9, the federal court, unlike the EFCB, could not have interfered so strongly in the fiscal affairs of the city. Unlike off-the-shelf bankruptcy protection, the state here decided to use an ad hoc approach tailored to the specific circumstances of the city. Among the few areas where the EFCB could not interfere were setting budget priorities, which remain the prerogative of elected city officials, and the right of employees to bargain collectively.25

2.2 South Africa

South Africa’s motivation for enacting a municipal insolvency framework differed from that of the United States. After the fall of Apartheid,
capital market lending to subnational governments had come to a virtual halt. The Treasury wanted to ensure municipal governments’ continuous access to the capital market and to avoid future subnational financial crises. Investors were concerned whether their debt would be repaid. The Parliament’s concern was how to protect a fledgling democracy, as addressing subnational insolvency touches on the role of the legislature, courts and local executives. These different interests came together to create a consensus for a municipal bankruptcy framework.26

During Apartheid, white communities, which were wealthier than black communities, could raise funds from the capital markets directly, based on their steady local revenues and even central guarantees. Defaults were absent, as were legal remedies. Black communities relied on central transfers and on-lending from a public financial parastatal that had the guarantee of central government.27

After the fall of Apartheid, the new decentralized constitution ended the guarantee of local debt. The democratic process requires the abolishing of racial jurisdictions. Municipal boundaries were redrawn in 1995 to combine poor black urban communities with wealthier white urban communities. The boundaries were redrawn again in 2000 to combine rural and urban communities in 2000.

These developments brought perceived uncertainty regarding the revenue strength of amalgamated municipal governments. Prolonged financial troubles of several municipalities without the prospect of resolution also dampened the confidence of lenders.28 Among financial market participants, the view was widespread that the discretionary financial resolutions were insufficiently insulated from political pressure, entailing risks of lobbying federal government to bail out troubled municipalities. Also, enthusiasm for giving banks strong remedies against democratically elected local officials was low. These factors, combined with the lack of legislative and judicial procedures for dealing with subnational defaults, greatly increased the risks perceived by lenders, resulting in little capital market lending to local authorities.29

The South African case points to the impact of existing institutional structure on regulatory reform. Under the old Section 139 of the Constitution (1995–2002), few remedies existed to effect debt and fiscal adjustments for a financially troubled local government. Under the old Section 139, budgets, spending and taxes were under the purview of the local legislature. Intervention into local government affairs was limited to cases where an “executive obligation” was not fulfilled. The province could only issue “a directive to the council” and/or “assum[e]responsibility” for the obligation.

Two constitutional amendments paved the way for a municipal
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The new Section 139 is entitled “intervention” in lieu of “supervision”. Intervention is strong, with potential substantial loss of local political autonomy. The amendments also strengthened court independence. Only courts can stay debt payments and discharge debt obligations. The Municipal Finance Management Act, enacted in 2003, contains a new framework for municipal finance and borrowing. Chapter 13 of the Act spells out detailed criteria for interventions and recovery plans, specifies the role of higher-level governments and courts in the insolvency mechanism and outlines the fiscal and debt adjustment process.

Types of interventions include the issuance of directives, full loss of municipal autonomy in financial matters under a mandatory intervention, and dissolution of the Municipal Council in extreme circumstances. Primary responsibility lies with the provincial government, but the central government may intervene when the province is unable or unwilling to act. Compared with Hungary, where the court-appointed financial trustee takes the center stage, in South Africa the provincial executive branch plays an important role.

The South African case demonstrates the complexity of subnational borrowing and insolvency legislation and the path dependency of reforms. It also illustrates the importance of building political consensus among differing interest groups. It took the country two years to develop the basic policy framework (1998–2000), another year for the cabinet approval (2001), followed by two years of parliamentary debate on the constitutional amendments and on the Municipal Finance Management Act (2001–2003).

2.3 Hungary

If South Africa’s motivation for developing a regulatory framework for subnational insolvency was to revive private lending to municipal governments, Hungary had two motivations in the mid-1990s. The first was to discipline lenders. Lending by public banks was viewed as indiscriminate and imprudent, without proper evaluation of creditworthiness. The lack of credit differentiation was attributed to the assumed central government guarantee for subnational debt and potential problems associated with public sector lending. The second motivation rose from the deteriorating financial performances of local governments, which foreshadowed contingent state liabilities. In financial distress, borrowers and lenders were expected to lobby strongly for bailouts.

The 1990 Act on Local Government granted Hungary’s local governments independence in financial management. Municipalities had
unfettered freedom to manage their finances and started to borrow for commercial activities, thus increasing the risks of insolvency. The macroeconomic deterioration in 1995 exposed the seriousness of subnational financial distress. Furthermore, municipalities began to borrow long term to finance short-term operating deficits. Several local governments successfully lobbied for one-time grants from the central government. This threatened to set a bailout precedent, raising concerns of adverse incentives for local governments and for creditors. Representatives of several commercial banks argued that these loans were for the public benefit and deserved bailout by the state.

Several options were debated at the time. The first option was for the central government to credibly adopt a no-bailout policy. The second option was to impose restrictions on borrowing and strengthen monitoring and enforcement. The third option was to rely on informal restructuring negotiations between major financial institutions and local governments.

Even though informal negotiations may lead to debt adjustment, they could not formalize debt restructuring procedures, the transparency and predictability of which are central to an effective subnational insolvency mechanism. In the end, maintaining essential public services, protecting debtors, creditors and the state budget, while clarifying what would happen in defaults, justified a debt adjustment law. The Law on Municipal Debt Adjustment (Law XXV) was approved by the Hungarian Parliament in March 1996 by an overwhelming majority. The Debt Adjustment Procedure consists of seven major phases: (1) initiation; (2) court review of the petition; (3) formation of a debt adjustment committee; (4) adoption of a crisis budget; (5) financial reorganization plan; (6) debt agreement negotiations and (7) asset liquidation if no agreement is reached.

Hungary differs from South Africa and the United States in one important way, namely the central role of courts in fiscal and debt adjustment for local governments in Hungary. In both South Africa and the United States, the courts’ role is limited. They guide the parties in their negotiations and grant an eventual debt discharge, but provinces and the central government in South Africa and many states in the United States can directly effect fiscal and debt adjustments of financially troubled local governments. In Hungary, courts play the central role in the debt and fiscal adjustment.

2.4 Brazil

Brazil has opted for an administrative approach to subnational insolvency, in contrast to the United States, South Africa and Hungary where the role of the judiciary is more pronounced. Since the 1980s, Brazil has
experienced three state debt crises (Ter-Minassian, 1997 and Dillinger, 2002). The complex structure of fiscal federalism caused a lack of fiscal co-responsibility and the absence of hard budget constraints by lower levels of government. There was no control of subnational debt. On several occasions, the federal government bailed out states and municipalities. From the late 1980s to 1990s, the federal government restructured subnational debt three times.

In the two earlier subnational debt crises (1980s and the early 1990s), the central government bailed out insolvent subnational entities. And during the third subnational crisis (1997), the central government intervened directly, pushing difficult structural reforms to tackle the root causes of insolvency, instilling fiscal transparency and essentially imposing a fiscal and debt adjustment package based on reform conditions.

The first debt crisis was a legacy of the international debt crisis of the 1980s, when states, along with the federal government, ceased servicing their debt to foreign creditors. After the federal government reached agreement with the creditors, in 1989, the federal government transformed the accumulated state and municipal arrears and remaining principal into a single debt to the federal government. US$19 billion was rescheduled. The second crisis involved debt owed by the states to federal financial institutions. The federal government refinanced debt in 1993 amounting to US$28 billion. The third and largest debt crisis was resolved through the conditional bailout of the federal government in 1997. The federal government restructured the states’ debt, equivalent to 11.5 percent of GDP.

Although with the first two debt workouts, the federal government made attempts to tighten the regulations on state borrowing, the efforts were insufficient. The 1997 debt workout was conditional upon each state’s compliance with fiscal and structural reform programs. The motivation for the conditional bailout was to resolve the moral hazard associated with unconditional bailouts. In exchange for the rescue package, the federal government negotiated agreements with 25 states in 1997 and 1998. These agreements were sanctioned by Law No. 9496 of September 1997.

Law No. 9496 established a comprehensive list of fiscal targets: a debt/revenue ratio, primary balance, limits on personnel spending, own-source revenue growth, investment ceilings and a list of state enterprises to be privatized or concessioned. Each state had to agree to such targets in exchange for financial relief. Crucially, the debt adjustment agreement collateralized resources for debt service and threatened withholding central government transfers in case of breach. Subsequent Senate Resolution No. 78, 1999 imposed fixed ceilings on new borrowing, debt servicing and the stock of debt. All these controls were strengthened by the 2000 Fiscal
Responsibility Law, which consolidated many restrictions and regulations into one unifying framework.35

2.5 Albania, Bulgaria, Macedonia and Romania

A group of Central and Eastern European Countries – Albania, Bulgaria, Macedonia and Romania – represents another set of interesting cases.36 These countries see a subnational borrowing framework (including an insolvency mechanism) as a crucial element to underpin fiscal decentralization and their fledgling subnational debt markets. Aspiration to European Union membership provides added impetus for such reforms.37

In Bulgaria, only the capital Sofia has issued international bonds.38 The near absence of a subnational borrowing market is commonly explained by an ambiguous borrowing framework, a lack of local budget and spending autonomy, weak local finances and a fragile banking system.39 The inability to issue subnational bonds to finance infrastructure projects has also hampered the ability to draw on the European Union structural funds.

In June 2005, borrowing legislation was approved. A working group was then established to propose a mechanism for subnational financial distress. Insolvency is outside the group’s term of reference. Bulgaria is the best example of a country looking at such a mechanism before signs of trouble appear. The lending community favors an insolvency mechanism. Bulgaria, by deciding to look into the merits of such a policy early, is able to start with a clean slate. However, the development of a regulatory framework for subnational borrowing needs to go hand in hand with improving the intergovernmental fiscal system, granting subnationals greater fiscal autonomy and reforming the financial markets.

Romania’s capital market for subnational borrowing has been developing at a faster pace than Bulgaria’s. Subnational debt is evenly divided between loans and bonds, with about 30 bond issues and 30 bank loans between 2002 and 2005. So far, lending has been limited to top-tier municipalities, small-scale projects and three- to five-year maturities for most offerings (recently maturities have been extended to up to 10 or 15 years for a few issues). To tap the European Union’s accession financing, subnational borrowing needs to expand in size and spread to more municipalities.

One reason for limited growth of subnational credit in Romania is the case by case approach to financial distress. Due to a lack of predictable rules, lenders are unable to assess default risk. Lenders worry about political influence and unequal treatment of subnational governments. They want clarity on available remedies against defaulting municipalities. A high-level working group has been established to develop legislation
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for municipalities in financial distress and insolvency. The aim is to further capital market development and establish proper incentives for lenders and borrowers. In corporate bankruptcy, Romania has already accumulated substantial experience over the past three years.

A similar effort is under way in Albania where the subnational debt market is just starting to develop with consideration of a comprehensive legislative framework for borrowing. The government is interested in establishing a framework early on based on the experiences of Hungary and other countries. Adoption of Albania’s subnational insolvency statute is imminent.

Today, Macedonian subnationals have no bank or bonded debt. The bulk of subnational debt consists of arrears to domestic construction companies. Legal disputes on the origin of debt as the result of merging and consolidating municipalities have raised uncertainty. The Macedonian case illustrates the tension between creditor rights and the need to maintain essential minimum services. Lenders went to court for overdue payments. The court judgments held that the lenders’ repayment claim was subordinate to essential minimum services. Yet funds are not enough to cover essential minimum services, leaving little to pay creditors. The legal framework for local governments provides for a monitoring and surveillance regime for local governments in financial distress; however, it lacks the powers of intervention and legal remediation to deal effectively with the current situation.

A legal limit on debt issuance was introduced because of high municipal debt. Yet, for the current debt overhang, the absence of an insolvency mechanism prevents a debt restructuring. Efforts are ongoing to establish a debt restructuring law. Debt relief would be conditional on fiscal reform and consolidation. In the meantime, a game of hide and seek is taking place between creditors and municipalities, with municipalities moving their accounts frequently to escape attachment by creditors.

3 PRINCIPLES OF SUBNATIONAL INSOLVENCY

Notwithstanding different motivations, experiences from Brazil, Hungary, South Africa and the United States demonstrate certain principles that are inherent in a sound regulatory framework for insolvency. These principles are: balancing the tension between the contractual rights of creditors and the need for maintaining public services in the event of financial distress and default, a hard budget constraint for subnational entities and a credible no-bailout promise by the central government, clear and predictable rules to anchor expectations and burden-sharing between the subnational
entity and creditors. Countries also face a choice between a judicial, administrative or a hybrid approach. Real-life mechanisms differ substantially, and the chosen design is in large part dependent on country-specific circumstances.

3.1 Comparing Public and Private Corporate Insolvency

Insolvency of subnationals is qualitatively different from private corporate entities. First, subnational governments provide public goods in fulfillment of mandated responsibilities. Second, compared with corporations, creditor remedies against defaulting subnationals are narrower. Third, while a corporation is able to self-dissolve, this route is barred for subnational governments. Fourth, the typical subnational has (or should have) some taxation power.

The core difference between the insolvency of private corporations and subnational governments is the public nature of the services provided by subnational governments. This core difference also explains the basic tension between protecting creditor rights and maintaining essential public services. Creditor rights are central to the development of capital markets; at the same time, providing essential public services such as police, drinking water and fire protection is the basic role of the government. In this sense, the satisfaction of creditor claims is subject to an absolute functional limit: the protection of the core functions of the subnational entity.

In the event of private corporate bankruptcy, all assets of the corporation are potentially subject to attachment. By contrast, the ability of creditors to attach assets of subnational governments is greatly restrained in many countries. The reasons for granting subnationals immunity from attachment are concern over potential disruption of the government and the need to assure that essential services will continue to be provided to the people.

When Hungary deliberated its subnational insolvency mechanism, it was recognized that the country’s corporate bankruptcy law, in force since the late 1980s, was not applicable to subnational borrowers. In the United States, a prominent judicial doctrine holds that only proprietary property is attachable. “Proprietary property”, subject to debt foreclosure, was defined by the US Supreme Court as “held in (the municipality’s) own right for profit or as a source of revenue not charged with any public trust or use”. Property dedicated to “public use” such as streets, hospitals or courthouses is exempt even in the absence of specific statutory protection, as are funds held in the local treasury for general use. As a result, the backstop of private creditor rights – the right to seize the property of the debtor – is often unavailable to the subnational debtors.
Another key difference between subnational and corporate bankruptcy lies in the procedure’s partial insurance function. This is the result of debt discharge when repayment would cause a sizeable decrease in the delivery of public services. The rationale is to protect the subnational entity and its population from long-term harm through a sharp decrease in public service delivery. Also, to allow a timely fresh start, one needs to balance incentives for the subnational entity to grow out of insolvency with repayment of creditors. As bankruptcy procedures lower the downside risk of borrowing, a higher bankruptcy exemption for essential public services will ceteris paribus lower the supply of financing (White, 2005). There is thus a trade-off. Where to draw this line is a crucial question in the design of such legislation.

Insolvency in the private sector is defined as a situation where a legal person or entity’s liabilities exceed its assets. The insolvency procedure usually involves selling off assets to satisfy payment of liabilities. Those liabilities remaining unpaid are then de facto written off in liquidation. Reorganization procedures restructure liabilities in a legal procedure to allow a fresh start for viable entities. In reorganization, courts are usually empowered to “discharge” debt (debt adjustment).

In the design of such procedures for subnationals, one needs to think outside the box of liquidation. In contrast to corporations, subnational governments cannot be liquidated like commercial enterprises, unless another entity assumes their governmental responsibilities. Invariably, subnational insolvency mechanisms can only be of the reorganization type. The entity continues to exist and the government remains in control, keeping some of its assets to ensure continued public goods provision. A quick economic recovery of the entity concerned is also in the best long-term interest of creditors as a group, since it heightens the probability of repayment. The overarching aim of the procedure is thus financial rehabilitation of the debtor, and maximum recovery for creditors consistent with this objective.

In summary, the policy justification and legal procedures for private sector insolvency do not readily transfer to subnational entities. This results in a number of insolvency design features unique to subnationals. The usual way of defining “insolvent” as liabilities greater than assets is of little use. Liquidation of all assets is infeasible, as at least some public assets are critical to carrying out important governmental tasks. These responsibilities are independent of the subnationals’ financial condition. Municipalities are governed by elected officials. Interference in the subnational’s sphere of responsibility is problematic, because of the political nature of rights and obligations. It may also run counter to constitutional protection and electoral choices.
3.2 Hard Budget Constraint for Subnational Entities

Unconditional bailouts of financially troubled subnational entities by the national government create moral hazard, encouraging fiscal irresponsibility with little concern for how debt will be serviced and imprudent lending without balancing risks and returns. A lax subnational budget constraint distorts the price signal guiding the allocation of credit, creates potential liabilities for the central government and endangers macroeconomic stability. The time will come for over-indebted entities to confront a difficult economic and political reality. Their policy choices will be between raising taxes, cutting spending, lobbying the central government for a bailout or seeking relief from creditors.

In the United States, the no-bailout principle was established during the first subnational defaults in the 1840s. In 1842, 11 States and the Territory of Florida were in serious financial trouble. States and investors lobbied the federal government for bailouts. The no-bailout principle had the upper hand, and eight states and the Territory of Florida defaulted their debt. The crisis prompted states to impose new limits on borrowing. Between 1842 and 1852, 12 states wrote new constitutions. Eleven adopted novel procedures for authorizing government borrowing. The principle of no-bailouts has been upheld over various subnational default cycles.

As illustrated by the Hungarian case, the motivation for establishing a regulatory framework for subnational insolvency was to reduce moral hazard, impose a hard budget constraint for municipalities and shrink contingent liabilities of the central government. After repeatedly bailing out subnational governments, Brazil followed a stricter approach, demanding subnational fiscal adjustment in return for fiscal relief. However, the mere existence of a hard budget constraint is not sufficient for nurturing the development of capital markets, as illustrated by the case of South Africa. The post-Apartheid decentralized constitution ended the guarantee of local debt. But the resumption of lending to municipal governments by the capital market did not start until the insolvency mechanism was put in place, with the clarity of rules as a central element of the mechanism.

3.3 Clarity of Rules

The twin aims of a subnational insolvency framework are to create a predictable and transparent framework for managing expectations about default and to coordinate competing interests on the subnational’s financial recovery. The first enables accurate risk pricing and credit differentiation, and prevents moral hazard. The second helps the subnational to restore fiscal sustainability, which not only allows the subnational to carry
out its governmental responsibilities while undergoing restructuring but also serves the collective interest of creditors.

Lack of clear rules for insolvency is likely to raise borrowing costs through higher interest rates, shorter maturity, or both, and thereby limits market access for creditworthy borrowers. The experience of Romania with municipal capital market shows this clearly: facing substantial uncertainty about available remedies upon default, private lenders are reluctant to supply credit to more municipalities, lower cost, or extend maturities. In the extreme cases, a lack of clear rules for insolvency can shut down the capital market altogether, as demonstrated by the experience of South Africa prior to the enactment of the Municipal Finance Management Act in 2003.

The insolvency framework aims to clarify rules on three key aspects of the insolvency process. The first aspect concerns orderly debt restructurings. The second aspect concerns the maintenance of essential public services. The third aspect concerns structural adjustment to restore subnational fiscal sustainability.

In the absence of a clearly-defined framework for insolvency, subnational governments may adjust debts in negotiations with creditors or repudiate their obligations. As the experiences of the United States, Hungary, South Africa and Macedonia show, ad hoc debt restructurings are complex. Interests of the subnational government, which is responsible for maintaining essential minimum services, and those of creditors, who insist on fulfillment of contractual promises, diverge. Oftentimes, reconciliation through a voluntary bargaining process proves elusive.

Clear creditor remedies allow collective enforcement and facilitate efficient debt adjustment. Creditor remedies in contract laws, instead of insolvency mechanisms, are effective to enforce discrete unpaid obligations. However, individual lawsuits or negotiations become ineffective if there is a general inability to pay. In systemic subnational insolvency, individual negotiations with each creditor are impractical, costly and potentially harmful to the interests of the majority of creditors. A small group of creditors may derail a debt restructuring agreement reached between the debtor and creditor majority. This holdout problem causes uncertainty and prolongs the debt restructuring process. Resolving the holdout problem was the primary motivation for the United States to enact the municipal bankruptcy legislation (Chapter 9) to clarify the rules for debt restructuring.50

On maintaining essential public services, there are three general approaches. In the first, the legislation specifies a closed list of essential services (assets) in detail.51 In the second, a broad clause protects those assets used for public purposes (essential services). This later distinction between property for public use and property for private use is a principle
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of subnational insolvency procedures. Such protection is at times found in a specific municipal insolvency statute; in the absence of a specific protective clause for subnational entities in the laws on attachment. Court may also decide on a case by case basis, taking into account the fiscal and debt adjustment agreement reached between the debtor and creditors. On fiscal adjustment, the insolvency mechanism, in combination with ex ante regulation, can define various stages of financial distress and insolvency, using clearly defined fiscal and financial indicators such as primary balance, debt service ratio, arrears and liquidity. It can also spell out judicial or administrative proceedings for restoring fiscal and financial health to the troubled subnational entity.

A well-designed insolvency procedure will have important ex ante effects anchoring the expectation of borrowers and creditors. For this reason, such a mechanism not only helps resolve financial distress ex post, but also deters irresponsible borrowing and imprudent lending ex ante. In the United States, Chapter 9 is rarely invoked. Chapter 9 is designed to carry a strong stigma for the borrowing municipality, to offset debtor moral hazard. Municipalities are thus wary that capital markets would interpret the filing for federal bankruptcy protection as a strong signal of financial mismanagement, to which lenders are likely to react by charging a risk premium.

In Hungary, four years after the 1996 Act on Municipal Bankruptcy, only a handful of municipalities (11 out of 3158) filed for bankruptcy protection. There is strong evidence that the legislation preempted more filings, because creditors and debtors were encouraged to seek redress outside the court system and to take other steps to ensure solvency and operational efficiency. Furthermore, financial institutions have been more prudent in lending to municipalities. Although voluntary resolutions without insolvency procedures are unlikely, the mere existence of a legal framework that could impose solutions often induces voluntary agreements.

3.4 Equitable Burden Sharing

Clear rules ease the distributional struggle typical of insolvency. The basic tension between the need to maintain essential minimum services and the creditor’s contractual rights implies that the pain of insolvency needs to be shared between lenders and creditors. The insolvency mechanism needs to balance competing interests. This distribution also matters ex ante, as it shapes the expectation and behavior of borrower and lender in the next cycle of borrowing.

In the aftermath of the Great Depression, Hillhouse described the situation in colorful words: “Every municipal default is like a drama in which there are many players. Bankers, lawyers, municipal bondholders, holders
of the unfunded obligations and real estate mortgages, local officials, taxpayers, municipal employees and civic groups, all play some parts.” To this long list, one should also add the central government. For example, in resolving the Brazilian subnational debt crises, almost the entire burden was placed on the central government.

What should a rational framework for subnational insolvency look like? This chapter argued above that there are many benefits to clarifying the rules. One key component is establishing ex ante the repayment order in insolvency, which helps prevent moral hazard and encourage pricing of default risk by lenders.

The collision of interests, a clash between creditor rights and the subnational debtor’s inability to pay, is here to stay. This clash is at its extreme when a debt discharge is needed, a major curtailment of creditor rights. Creditors will insist that all valid debts be honored and repaid. Ex ante, the subnational entity will pledge assets for financial resources; ex post, it will argue that many assets cannot be used for the satisfaction of creditors as they serve a public purpose. Can the public nature of the debtor justify curtailing creditors’ valid private law claims?

In principle the answer is an equitable sharing of misery. Many corporate insolvency systems provide for equal creditor treatment of similarly situated creditors, including similarly situated foreign and domestic creditors. Without a strong reason to depart from this principle, like creditors should be satisfied ratably. This principle would call, for example, for treating all bondholders equally. A subnational insolvency framework also provides guidance on the priority of settling competing creditor claims.

The economic literature on bankruptcy asserts that the absolute priority rule (APR) is optimal, since it provides the right incentives for lending ex ante (White, 2005). If lenders are repaid in the exact order of their lending, implying that no lender can jump the queue, then costs of additional lending are fully internalized and reflected in pricing. In other words, there is no risk of debt dilution, since the effect of the marginal dollar lent on the debtor’s payment capacity is fully incorporated in the costs of lending.

Yet in practice, no country has adopted a pure absolute priority rule. The reason is twofold. Although the APR rule might be efficient ex post, it need not be efficient ex ante. The rule may have a deterrent effect on new lending, even when such lending is desirable. Debtor-in-possession financing in US corporate bankruptcy law addresses this concern. Contrary to the APR rule, priority is given to new financing once the debtor is under bankruptcy protection. The convincing rationale is to allow refinancing in financial distress.

Second, distributing the pool of available assets in bankruptcy is never about efficiency alone. There are distributional impacts. The APR is only
one possible policy choice. Many other configurations of priority are possible. Which one is most appropriate for the insolvency of subnational entities will depend, first, on the distributional judgment of the society concerned and, second, on the effect of a chosen priority structure on the capital market and its impact on new financing during a liquidity crunch. It is also important to allow sufficient flexibility within a general priority framework.

In the absence of a clear priority structure, the defaulting borrower may choose the order in which to satisfy creditors. A subnational insolvency framework eliminates this source of arbitrariness by providing guidance on the priority of creditor claims. Yet the devil is in the details of “equitable priority structure”. This notion will differ across countries, reflecting society’s distributional judgments over sharing the insolvent’s dwindling pie of assets.55 The US approach in Chapter 9 of the Bankruptcy Code gives first priority to secured creditors and second priority to unsecured creditors, after essential public services and costs of the bankruptcy proceedings are paid for. Hungary chose to give preference to subnational employees over creditors as a group.

The priority structure for settling competing claims expedites the resolution of debt restructuring and payments. It also eases the pain of sharing the reduced assets for distribution, because the losses suffered by different creditor groups are more predictable and more likely to be accepted, and moreover, the structure can keep the absolute size of losses in check, since the costs of protracted negotiations and litigation are high and often take priority over other claims. The shadow of priorities provides the backstop for voluntary restructuring negotiations, shaping bargaining power of creditors and debtor even outside bankruptcy. Clearly, the priority structure is a policy choice, with a variety of trade-offs. If the lending community perceives that financial distress is entirely or mostly resolved on its back, then desirable future lending will suffer.

A reason for introducing a subnational insolvency mechanism might be a desire to change leverage in the debtor–creditor relationship. Much will depend on shortcomings identified in the current subnational borrowing arrangements. If the analysis revealed that the current system is tilted in favor of borrowers, then the insolvency framework could be designed to shift bargaining power to the creditor. If, on the other hand, creditors enjoy too much leverage, then the insolvency system could provide more protection to a subnational entity in financial distress.

3.5 Judicial versus Administrative Approach

This section contrasts two alternative approaches to subnational insolvency: the judicial and the political-administrative approach. In addition,
various hybrids exist. Judicial procedures place courts in the driver’s seat. Courts make key decisions to guide along the restructuring process. Administrative interventions, by contrast, usually allow a higher level of government to intervene in the entity concerned, temporarily taking direct political responsibility for many aspects of financial management.

The judicial approach tends to target insolvency and is triggered by the filing of a petition. Under the administrative approach, a higher-level government typically intervenes earlier to prevent deterioration of subnational fiscal distress into insolvency. The judicial approach is rarely used in the United States, as Chapter 9 serves primarily as a deterrent. The states in the United States have adopted various approaches to resolving local financial distress. New York and Ohio represent two broad intervention types: an early warning system to prevent local governments from slipping into fiscal distress (Ohio), and strong ex post intervention by the state to restore local government solvency (New York).

While Chapter 9 in the United States, and Hungary’s legal insolvency mechanism deal with insolvency through the courts, South Africa’s legal framework is a hybrid, blending administrative intervention followed by judicial intervention if the financial distress deteriorates into insolvency. There are three steps in South Africa in the event of municipal financial distress: an early warning system consisting of various indicators, intervention by provincial governments and then by the central government and intervention by the judicial system in debt restructuring. Brazil has chosen an administrative approach to dealing with subnational insolvency. The choice of procedure links in part back to the motivation. In Hungary, for example, a desire to neutralize political pressure during the restructuring favored the judicial approach.

The earliest documented attempt of introducing a municipal insolvency procedure occurred in Switzerland. In 1883, four municipalities were on the brink of insolvency after a guarantee for the benefit of the Swiss National Railway Corporation was triggered. Insolvency was only averted by a sizeable federal bailout. This crisis prompted a search for a legal framework for municipal insolvency.

Friedrich Meili (1885), a renowned Swiss law professor, undertook a comprehensive survey on municipal insolvency for the Swiss federal government, and put forward a detailed proposal for a law. Meili regarded the crisis of the four municipalities as a welcome opportunity to introduce clarity into the relationship between municipalities and their creditors. In his view, like to so many who followed, the main benefit is legal certainty. The inherent political character of subnational entities is a key consideration in design. Many subnational governments are elected. Their
removal by administrative fiat or by a judge might directly conflict with the democratic governance at the subnational level. This need to safeguard internal decision-making, which is peculiar to public bodies with elected officials, is referred to as “sovereignty concerns”.

The United States displays an interesting variant of such sovereignty concerns. Chapter 9 vests jurisdiction in federal courts; this raises sovereignty concerns, since municipalities are creatures of the states. The solution adopted is the specific authorization requirement of Chapter 9. As a result, the federal bankruptcy courts cannot interfere with a state’s ability to control its municipalities.

Outside insolvency, sovereignty concerns are apparent in the limitations on seizure of subnational property, which are found in many jurisdictions. Under this rule, a private person cannot attach public property for satisfaction of a debt. In extreme cases, attachment could endanger the municipality’s functions. Importantly, if a court were to order such attachment, it would put the judicial branch in direct conflict with the subnational-administrative branch. As courts lack the political legitimacy for deep interference in financial affairs, sovereignty concerns are more pronounced under the judicial approach.

A narrow scope of intervention is one way of safeguarding subnational autonomy. Under Section 904 of the United States Bankruptcy Code, the Federal Court’s jurisdiction depends on the debtor’s volition and cannot be extended beyond it. Financial management remains the responsibility of the municipality. The court may not interfere with the municipality’s choice on services to citizens. It is the municipality’s prerogative to prioritize spending, within the envelope established through the adjustment plan. Hence, the insolvency mechanism is separate from internal decision-making. Court-ordered replacements of politicians are ruled out.

4 SUBNATIONAL INSOLVENCY FRAMEWORK: KEY ELEMENTS

This section analyzes key elements of subnational insolvency frameworks based on the experiences of the United States, Hungary and South Africa. The focus is on central elements, to illustrate typical design choices a country faces when developing subnational insolvency mechanisms. The section does not discuss their full legal complexity. The section defines insolvency, which serves as trigger for the procedure, and discusses collective enforcement. The section then analyzes the dual adjustments during the insolvency proceeding. The first adjustment – fiscal adjustment by the
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debtor – is to bring spending in line with revenues and to bring borrowing in line with debt service capacity. The second adjustment is negotiations between creditors and the debtor to restructure debt obligations and potential debt relief.

4.1 Insolvency and Commencement of Bankruptcy

What is meant by “subnational financial distress” and “subnational insolvency”? While the economics literature defines insolvency in relation to the sustainability of fiscal policies, a specific legal definition serves as “procedural trigger” for initiating insolvency proceedings. The typical administrative approach to subnational insolvency kicks in earlier than judicial procedures. The higher level of government may intervene in financial distress, before the subnational’s financial situation deteriorates into insolvency.

In a legal sense, insolvency refers to the inability to pay debts as they fall due. Yet details vary across countries. In the United States, insolvency is defined as the debtor either: (1) currently not paying its debts as they become due, unless such debts are the subject of a bona fide dispute, or (2) not being able to pay its debts as they become due. In Hungary, the two central triggers are: the debtor (1) has neither disputed nor paid an invoice sent by a creditor . . . within 60 days of receipt or of date due if the due date is later; (2) has not paid a recognized debt within 60 days of date due. In South Africa, by contrast, chose one set of triggers for serious financial problems, and another for persistent material breach of financial commitments. If the first set of triggers is met, the provincial government may intervene. Under the second set of triggers, intervention is mandatory. Unsuccessful provincial intervention calls for national government intervention. Independent of these interventions, the municipal government can apply to the High Court to stay all legal proceedings against the municipal government, and to relieve, suspend or discharge financial obligations.

In all three countries, the bankruptcy code empowers the bankruptcy court to dismiss petitions not filed in “good faith”, to prevent filing for bankruptcy despite ability to pay. Since bankruptcy procedures have the power to discharge debt, a subnational entity may be tempted to file purely for the purpose of evading debt obligations.

In the United States, the cash-flow definition of insolvency for municipalities differs from the balance sheet insolvency test used for corporations. For municipalities, the code looks to cash flow, while for other debtors, it looks to assets and liabilities. Even a municipality with many valuable assets can be insolvent. This reflects the common law view before the United States Bankruptcy Code, which treated the municipality as a
debtor with few physical assets available for creditors and instead focused almost exclusively on the ability of the debtor to generate revenues through property tax.67

The insolvency standard in the United States serves as an effective gatekeeper, discouraging unnecessary municipal bankruptcy filings. The Bankruptcy Code erects obstacles to municipal filing beyond those faced by private debtors. Only municipalities face a statutory requirement of insolvency. Section 109(c) imposes a procedural bar that is unique to Chapter 9 debtors: it requires pre-filing efforts by the municipal debtor to work out its financial difficulties. The debtor must have reached agreement towards a plan, have failed to do so despite good faith negotiations or such negotiation must be “impracticable”. And, municipalities need state authorization to file for bankruptcy [(109 (c) (2)].68

A subnational government can be financially distressed, yet solvent. Financial distress can be measured by various indicators, such as the ratio of current expenditure over revenues. The resulting operating deficit determines needed borrowing (a warning signal) and the ratio of debt service to total revenues, which measures the capacity to service debt. Each country’s definition is different. For example, Brazil defines the debt service ratio as share of current revenue net of transfers (Brazil, 2001), Colombia defines it as share of operational savings (Colombia, 1997), Peru defines it as share of current income including transfers (Peru, 2003) and Russia defines it as share of total budgetary expenditures (Russia, 1998). Fiscal responsibility laws in various countries cap the ratio beyond which a subnational is deemed to experience debt distress.

Who can file for bankruptcy? The class of eligible filers differs across countries. In the United States, only the municipality can file for bankruptcy under Chapter 9, conditional on being insolvent, having worked or attempted to work out a plan to deal with its debts and having been authorized by the state to file for bankruptcy.69 The more stringent requirement for filing under Chapter 9, as compared with filing under Chapter 11, is due to the constraint set by the US Constitution. A creditor cannot bring a municipality, against its will, into a federal court, based on the 11th amendment of the US Constitution. In South Africa, any creditor can file a claim against the municipality.70 Similarly, in Hungary, a creditor can petition the court if a municipality is in arrears of more than 60 days.71 Schwarcz’s model law allows only municipalities to file.72

4.2 Collective Enforcement

An insolvency proceeding is the process by which a financially distressed subnational entity resolves its debts collectively, as opposed to
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various individual and uncoordinated attempts at enforcement. Central to this process is a collective framework for simultaneously resolving debt claims when eligible assets fall short of liabilities. Following the Great Depression, Hillhouse (1936) emphasized that the main aim of insolvency for public entities is to avoid unnecessary waste of time, money and energy by all parties that arise in countless unsuccessful attempts at individual enforcement.

The coordinating role of insolvency mechanisms is central. The implicit assumption is that the self-interest of creditors (as a group and taken individually) may at times diverge, at least over the medium term. This could result in a breakdown in voluntary restructuring negotiations. In such circumstances there is a need for a procedure able to bind in holdout creditors, who refuse to go along with a restructuring.

The holdout problem arises from heterogeneity of stakeholders. For this reason voluntary negotiations may run out of steam and fail to provide a long-term solution. The underlying premise is that majority acceptance of an adjustment plan indicates that – in the majority’s judgment – the plan is in line with the entity’s capacity to pay. A holdout creditor may obstruct restructuring negotiations by refusing to accept the agreement, bringing suit on the original contract and trying to execute against attachable property of subnational entity.

The collection options against subnational governments tend to be limited, compared with corporations or individuals. The race to the courthouse is therefore a less salient concern. The need for a stay to conserve the current situation remains strong. A stay provides breathing space to the subnational entity to negotiate in good faith with its creditors, unobstructed by lawsuits. Current subnational insolvency procedures all incorporate such a stay in one form or the other. A stay is an authorization by the bankruptcy authority freezing ongoing litigation and prohibiting further financial transactions. In the US the stay is automatic; in South Africa court approval is required.

A well-designed system should provide strong incentives for collective action encouraging creditors and lenders to conduct restructuring negotiations early. Negotiated adjustments involving all stakeholders are the most cost-effective and efficient tool to resolve financial distress. If the shadow of insolvency is too remote and interests diverge, such voluntary bargaining will fail. This provides the rationale for off-the-shelf insolvency legislation for subnational entities. In systemic crises, there may be a need for interim framework enhancement measures tailored to the circumstances of the crisis at hand, without undermining the basic arrangements of the established insolvency framework.
4.3 Fiscal Adjustment

Fiscal adjustment and consolidation are preconditions for financial work-outs and recovery. If the municipality and other stakeholders do not address the root causes of insolvency, and yet all debts were discharged through some insolvency mechanism, then the subnational government could jump onto another cycle of fiscal mismanagement and financial distress.

Financial distress and insolvency are often the result of fiscal mismanagement. The fiscal crisis of New York City in 1975 was the result of spending persistently exceeding revenues and an oversized public sector (Bailey, 1984). In South Africa, fiscal mismanagement and failure to raise revenue were major causes of subnational financial crises after the ending of Apartheid regime (Glasser, 2005). Borrowing for commercial activities and for operational deficits (both should be prohibited) and unchecked fiscal management prompted financial distress of many Hungarian local governments in the first part of the 1990s (Jokay et al., 2004). Fiscal deterioration of Indian states in the late 1990s was attributed to rapid increases in salaries, pensions and subsidies; and rising debt services as the result of rising borrowing cost and increases in borrowing to support growing operating deficits.

Contingent liabilities associated with fiscal support to the public sector units, cooperatives and the statutory boards heightened fiscal risks (Ianchovichina et al., 2006). Besides fiscal mismanagement, macroeconomic shocks also impact subnational insolvency. Macroeconomic crises – currency depreciation, inflation and rising interest rates – exacerbated the vulnerability of subnational fiscal positions and led to massive subnational defaults in countries such as Mexico (1994–95), Russia (1998–99) and Argentina (2000–01). However, macroeconomic crisis was not the sole cause of the subnational debt crisis in these countries; it only exposed and exacerbated the vulnerabilities already rooted in the subnational finances. Deficiencies in the intergovernmental fiscal system, expected guarantees by central governments for subnational debt and non-transparent fiscal accounting all contributed to the subnational debt crises in these countries.

Ianchovichina et al. (2006) present a framework for analyzing subnational fiscal adjustment. Subnational debt sustainability is influenced by economic growth of the subnational economy, real interest rates and the subnational’s primary balance. They argue that 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 finance system. Unable
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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 influences on key expenditure items such as wages and pensions. If public sector banks dominate lending, lending rates could be subsidized, bank lending to subnational entities could exceed the statutory requirements and credit risk concerns could be compromised. Many policies that affect the economic growth and the fiscal health of the subnational economy are designed largely or exclusively by the central government.

Even in a decentralized system such as in the United States where subnationals have broad freedom to control expenditures, raise revenues, affect the interest rate spread in a competitive capital market and influence growth environment, fiscal adjustment often requires difficult political choices of cutting expenditure and raising revenues. In the administrative approach to insolvency, the scope of intervention by higher levels of government in subnational fiscal adjustment is often extensive. Judicial interventions vary across countries, depending on the relationships among the judicial, executive and legislative branches. Since courts are to interpret law but not to legislate, and the courts in many countries are independent of the executive branch, courts’ interventions into subnational fiscal adjustment are narrower than under the administrative approach.

In the United States, Chapter 9 of the Bankruptcy Codes explicitly protects the right of the state to control its political subdivisions and the right of the municipal debtor to manage its internal affairs. Section 904 provides that the court may not interfere with the “political or government powers of the debtor” the “properties or revenues of a debtor” or the “debtor’s use of or enjoyment of any income-producing property”. The effect is to preserve the power of political authorities to set their own spending priorities, without constraints imposed by the bankruptcy court. As part of fiscal adjustment the court can issue mandamus. This is not direct judicial interference in the political subdivision of the state, but enforcement of the power granted by the state to municipals to levy taxes for debt payment. In contrast to the narrow judicial role in fiscal adjustment of municipalities, state laws in the United States for distressed municipalities commonly provide for a transfer of control over municipal affairs. This confirms that in the United States non-interference is an artifact of federalism rather than an expression of inherent autonomy of municipalities. The cases of New York City’s fiscal crisis and the Ohio Fiscal Watch Program illustrate the state’s direction of municipal fiscal adjustment. Court interventions, by contrast, tend to be less intrusive.

In Ohio, the Fiscal Watch Program is implemented by the Office of
Auditor of State. The program has a detailed list of indicators (such as wage arrears, deficits, payment arrears, cash shortages, and so on) to monitor the fiscal health of local governments. The Fiscal Emergency Law has three intervention modalities: fiscal caution, fiscal watch and fiscal emergency. If a local government’s fiscal deficit exceeds one-twelfth of its annual revenue, the State Auditor issues a fiscal watch warning. Local authorities then need to limit spending and build reserves. The Auditor of State provides advice, for example, on performance audits, outlining options for budget cuts and operational improvements.

Once a local government is declared in emergency, the state establishes a financial planning and supervisory commission. The municipality needs to submit a detailed fiscal adjustment plan to restore financial health. The commission has the power to review taxation, spending and borrowing policies to ensure consistency with the fiscal adjustment plan, to bring civil actions to enforce the Fiscal Watch Program and to ensure proper accounting and reporting.

Higher levels of government prescribe transparency in reporting and auditing. This is an unsurprising common feature of subnational fiscal adjustment across countries. As a key aim of fiscal adjustment, it helps a subnational government re-access capital markets. Without fiscal transparency, private creditors cannot accurately price credit risk. As part of the administrative intervention for the city of New York, the Office of Special Deputy Comptroller for New York City was created to improve the accounts jointly with the Financial Control Board. The purpose of the Financial Planning and Supervisory Commission in Ohio is to ensure that the accounts, accounting systems and financial procedures and reports comply with the rules established by the Auditor of State. By the same token, fiscal transparency in accounting and reporting is a key element of recent fiscal responsibility legislation in Brazil, Colombia and Peru.

### 4.4 Debt Restructuring and Discharge

Debt restructuring lies at the heart of any insolvency framework – judicial or administrative. Without an insolvency framework, subnationals and their creditors can only resort to consensual and ad hoc restructuring negotiations. Success in such restructurings is often elusive, especially when debtor–creditor and within–creditor interests diverge. Collective action is a central challenge among creditors. Coordination is harder the larger and the more anonymous the group of lenders. These features are more pronounced for subnational bonds issued to different and numerous lenders. When a voluntary arrangement cannot be reached, the cram-down power given to an independent party becomes critical.
In administrative interventions, the higher level of government often restructures the subnational’s debt obligations into longer-term debt instruments. In the case of New York City, the Municipal Assistance Corporation was set up to issue longer-term bonds of the state to repay maturing short-term obligations of the city. In Brazil, the federal government has routinely restructured the subnational debt. However, fiscal austerity or subnational fiscal adjustment needs to accompany debt restructuring, to minimize the moral hazard of debt restructuring. This was precisely what happened to New York City in 1975 and to Brazil in the 1997 debt restructuring agreement between the federal government and states.

While administrative approaches tend to focus on debt restructuring, independent courts are viewed as best equipped to discharge debt. Debt discharge is a major departure from the principle that contracts ought to be fulfilled. Overriding contracts requires strong justification. A mature judicial mechanism is well placed to ensure that discharges are fair and equitable. As a result, discharges are typically limited to judicial mechanisms. In South Africa, for example, the municipality needs to go to the court for a discharge. Administrative procedures, on the other hand, tend to lack the power to discharge debt.

Ex post modification of contracts needs to be tightly circumscribed. 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. While the procedure could narrowly focus on debtor moral hazard, purely exogenous factors could have caused the subnational’s inability to pay. Absent imprudent lending, this potentially still leaves an irreconcilable gap between binding contractual commitments and payment capacity.

Debt restructuring and debt discharge is a complex process. This chapter is interested in two basic questions: whether creditors and the debtor can reach an agreement on debt resolution; and who holds the cram-down power when both sides fail to reach an agreement, or when the agreement is rejected by class of creditors.

In US municipal bankruptcy law, the municipal debtor controls the debt adjustment plan and modifies the terms of existing debt instruments. The critical question is what the debtor can do over the objection of creditors. The standards for confirming a Chapter 9 plan are complex. Nonetheless, Chapter 9 incorporates basic Chapter 11 requirements: at least one impaired class of claims approves the plan; secured creditors to receive at least the value of the property securing the plan; unsecured creditors often lose out.

In private insolvency, objecting unsecured creditors are entitled to be
paid in full as long as stockholders receive any value on account of their stock. Subnationals have no stockholders. Their officials need not pay off unsecured creditors to remain in control. Therefore unsecured creditors would look for protection to Section 943 (b) (7) of Chapter 9, which requires the court to decide that the plan is in the “best interests of creditors and is feasible”. The court would ensure that bondholders effectively receive what they would have received outside of bankruptcy if they were able to obtain mandamus relief requiring an increase in the taxes.82

In Hungary, the Debt Committee is chaired by a court-appointed financial trustee, who is completely independent of the local government under proceeding. The Committee is charged with preparing a reorganization plan and debt settlement proposal.83 Fiscal and debt restructuring proposals are decided by a majority vote of the Committee and presented to creditors. A debt settlement is reached if at least half of creditors whose claims account for at least two-thirds of total undisputed claims agree to the proposal. Creditors within the same group must be treated equally.84 The Act also stipulates the priority of asset distributions. If disagreements arise on distribution, the court makes the final decision, which cannot be appealed.85

South Africa’s legislation stipulates that debt discharge and settlement of claims must be approved by the court. The settlement of claims follows the following order specified by the law: secured creditor provided that the security was given in good faith and at least six months before mandatory intervention by provinces; thereafter preferences provided by the 1936 Insolvency Act; and non-preferential claims be settled in proportion to the amount of different claims.86

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.87 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.

5 LESSONS AND CONCLUSIONS

This final section draws out lessons for middle-income countries in Asia, Latin America and Eastern Europe. It highlights policy considerations and trade-offs in designing subnational insolvency procedures.

A good subnational insolvency mechanism encourages voluntary
bargaining in the shadow of bankruptcy law, anchors risks and rewards of borrowing ex ante, is tailored to the specific country circumstances and is perceived as balanced (“equitable”) by all stakeholders.

Subnational insolvency mechanisms are just one element in the broader subnational borrowing framework. 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 the subnational borrower and thereby enhance the effectiveness of preventive rules. Without an ex post insolvency mechanism, ex ante regulation can easily turn into excessive administrative control and game-playing between the central and subnational governments.

Furthermore, subnational insolvency mechanisms are embedded in contract and securities law and complemented by constitutional and administrative law on financial management (Maco, 2000). Improved decentralization frameworks and expanded subnational fiscal autonomy underpin a subnational’s fiscal strength. Such strength is fundamental to the subnational’s access to capital markets.

The mere existence of subnational insolvency mechanisms shapes incentives ex ante. Aligning incentives of all players and establishing a predictable set of rules for allocating default risk are at the heart of insolvency mechanisms. These incentives encourage lenders and debtors to comply with rules voluntarily, because if they do not, they suffer the consequences. While the full financial implications of default cannot be spelled out ex ante, subnational insolvency procedures go a long way in anchoring restructuring and negotiations. For example, the principle of sharing the pain between lenders and borrowers tends to encourage careful lending decisions and accurate risk pricing. Lenders are aware of the circumstances under which they may have to take losses. This enhanced predictability on returns to capital is likely to lower the cost of lending to creditworthy subnationals.

Insolvency procedures strengthen the hard budget constraint. Pressure for political ad hoc intervention decreases, as restructuring becomes institutionalized. Enhanced credibility for the non-bailout promise better aligns incentives. By standing on their own feet subnationals become miniature sovereign borrowers. They know that over-borrowing particularly for operating deficits implies painful adjustment. Subnational insolvency procedures also serve several macroeconomic goals. First, effective insolvency and creditor rights systems allow better management of financial risk. Minimizing systemic risk in the banking sector enhances financial stability. Second, they ensure efficient access to credit and allocation of resources (World Bank, 2005).

One potential downside of judicial procedures is cost and duration. In the US, some Chapter 9 cases are complex and expensive. The most
prominent example is Orange County’s bankruptcy. For a small subnational entity the costs of such proceedings could be substantial compared with assets available for distribution to creditors. Furthermore, speed matters in debt renegotiations. Proceedings dragging on for years unecessarily delay the entity’s economic recovery. This concern is more pronounced in underdeveloped judicial systems. Yet collective enforcement via subnational insolvency mechanism, as opposed to individual creditor remedies, builds incentives for parties to reach agreement within a reasonable timeframe (Schwarzc, 2002). Finally, lending to less creditworthy subnationals could decrease. In some countries, this will raise considerable equity concerns over uniform public service provision across the national territory. A more effective policy alternative is to use the intergovernmental grant transfer system instead of capital markets to narrow interregional gaps in public goods provision.

Subnational insolvency procedures become more important as the subnational bond markets deepen. The competition between subnational bank lending and bond financing tends to lower lending costs and extend maturities. However, a large number of bondholders exacerbate the principal-agent problem, requiring an insolvency framework to reduce protracted and costly negotiations between the debtor and numerous creditors. If a country relies largely on relationship-based banking, the need for an insolvency framework is less pressing.

Subnational insolvency procedures also become more important as a country decentralizes expenditure, taxation and borrowing decisions to lower levels of government. The insolvency mechanisms can help neutralize political pressures for overborrowing and bailouts. The lack of a subnational insolvency procedure is a smaller concern where the higher levels of government exercise tight control over subnational borrowing and where there are few signs of over-borrowing. If serious fiscal imbalances at the subnational level persist with little borrowing, then a reform aligning the transfer system could go a large way toward resolving the underlying fiscal imbalances.

Competing considerations need to be balanced in designing subnational insolvency procedures. First, creditors need to be repaid enough such that the private sector provides future credit on reasonable terms. Second, continued provision of public goods requires that some assets of the subnational entity be exempt from bankruptcy. Third, it is important to resolve the tension with subnational autonomy, and potentially the government’s electoral mandate. Fourth, the design needs to be consistent with the broader cultural, economic, legal and social context of the country. Many desirable design features, as apparent from different motivations of present subnational insolvency legislation, are country-specific.
Policy objectives of debt restructuring and the subnationals’ circumstances influence design. For example, countries differ considerably in how they balance forgiveness against creditor recovery and the stigma attached to default. Furthermore, the constitutional setup affects (but does not determine) the choice of an administrative, judicial or hybrid approach. In the United States, for example, municipalities possess no constitutional personality. Thus, theoretically, they can be created, destroyed and reorganized by their state. In other countries, municipalities previously enjoyed (federal) constitutional protection. One example is South Africa, where the constitution was amended to permit provincial interventions.

Capacity and entry point matter. The maturity of the legal system influences the “optimal” choice of procedure. Implementation of insolvency procedures – in the corporate and the subnational context – rests on the shoulders of insolvency experts and on institutions (courts) resisting political influence and corruption. In many emerging economies, 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. This interim solution can be used to build up institutional and professional capacity and restructuring expertise (Gitlin and Watkins, 1999).

Lack of comprehensive and timely information is another major constraint. Fiscal transparency and adequate reporting systems, in the lead up to financial distress, are preconditions for successful insolvency mechanisms. Corporate bankruptcy law relies on full disclosure of assets and liabilities. Similarly, subnational insolvency procedure would require public disclosure of comprehensive financial information, including hidden and contingent liabilities.

A commonly held belief asserts that default happens only where subnational entities and the central government are financially weak. The evidence belies this statement. Subnational financial distress is an increasingly common phenomenon in many middle-income countries. Subnational insolvency mechanisms ought to be on the reform agenda in a wide range of developed and developing countries.

NOTES

* The authors appreciate extensive discussions with Michael De Angelis, whose comments have been incorporated. We thank Matt Glasser on the case of South Africa and Mihaly Kopanyi on the case of Hungary. We also benefited from discussions with
Michel Noel, Christoph Paulus, Adolfo Rouillon and Steven Webb. This paper incorporates feedback from a Bankwide seminar. The findings and conclusions expressed herein are those of the authors. They do not necessarily reflect the views of the World Bank and, its affiliated organizations, or those of the Executive Directors of the World Bank or the governments they represent. The World Bank does not guarantee the accuracy of data included in this work.

1. The term subnational refers to those public entities in the tiers of government lower than the federal or central government. Subnational entities include states/provinces, counties, cities, towns, public utility companies, school districts and other special-purpose government entities that have the capacity to incur debt. The term subnational capital market refers to both the banking system and the bond markets.

2. See Eddy and Richter (2000, pp. 9–10), on international capital financing of subnationals.


4. The sub-sovereign bond market has grown vigorously, until recently, since its re-emergence in 2001 and became the largest sub-sovereign market among emerging economies with US$5.6 billion bonds outstanding as of June 2006 (Noel et al., 2006). As part of the fiscal stimulus package, China plans to issue US$30 billion subnational bonds in 2009 (China Ministry of Finance press conference, 17 March 2009).

5. Based on the findings of the Subnational Development Working Group of the World Bank, of which one of the authors for this chapter (Liu) has been a member.

6. In 1 January 2006, subnational bonds outstanding reached US$2.2559 trillion. This represents close to 10 percent of the US domestic bond market and 26 percent of all US public sector bonds (authors’ calculation is based on World Bank, 2006). The figure of US$400 billion issues is from Petersen (2005).

7. For a survey of recent developments in controlling subnational borrowing in several emerging economies, see Liu and Waibel (2005).

8. This chapter uses insolvency and bankruptcy interchangeably. These two terms refer to the financial condition of a particular subnational entity. We add “mechanism” or “procedure” to refer to the legal framework.


11. For discussion on Japanese local debt, see Schwarcz (2002). Moody’s (2002) eight subnational default studies covering France, Italy, Switzerland, the UK, Argentina, Brazil, Mexico and Russia provide quantitative and qualitative evidence of a limited number of documented defaults and numerous cases of non-payment and distressed exchanges. Sars (1999, pp. 1–2) provides evidence on Western Europe (“As illustrated by these cases, local governments sometimes do face financial distress despite the strength and stability of the underlying local government system”). Spiotto (1984) lists 6195 defaults on US municipal bonds from 1839 to 1969.


13. The interaction of borrowing constraints and service delivery, though not the focus of this chapter, deserves further study.


15. Interestingly, Germany, whose subnationals have traditionally relied on bank financing,
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is actively exploring a subnational workout procedure because of the difficult financial position of many municipalities. See Paulus (2003), and Wissenschaftlicher Beirat beim Bundesministerium für Finanzen (2005).


17. This was the first legislation of its kind in the world, even though other countries have contemplated the introduction of similar mechanisms earlier (for example, Switzerland in the second half of the nineteenth century, see Meili, 1885). In 1934, the US Supreme Court had declared a previous version of this legislation unconstitutional, see Ashton v. Cameron County Water Improvement District No. 1, 298 U.S. 513.


19. For a more detailed and excellent account on the mandamus and its implications for the motivation for Chapter 9 of the US Bankruptcy Code, see McConnell and Picker (1993).


23. The MAC was created by the State Municipal Assistance Corporation Act and other enabling legislation.

24. The state asserted its power by declaring an emergency in the Financial Emergency Act. The Act created the EFCB and adopted other financial emergency measures to prevent the city from defaulting on its bonds.

25. While the EFCB never explicitly violated these limits, the impacts of its policies did (Bailey, 1984).

26. We benefited from discussion with Michael De Angelis and Matthew Glasser.


28. For example, Butterworth, Noupoort, Ogies, Stilforntein, Tweeling, Viljoenskronn, and so on, Glasser (2005).

29. Based on Glasser (2005) and discussion with Michael De Angelis. Provinces in South Africa do not access capital markets as provinces do not have own-source taxes.


31. This section is largely based on Jokay et al. (2004).

32. For example, Bakonzeg, Nagocs, Batorliget and Paty (see Jokay et al., 2004).

33. Unless otherwise noted, the discussion on Brazil is mainly based on Ter-Minassian (1997) and Dillinger (2002).

34. Only two states (Tocantins and Amapá) did not have any bonded debt, and hence did not participate in the refinancing agreements.

35. For a detailed survey of legislations, see Liu and Waibel (2005).

36. Unless otherwise indicated, this section benefited from discussion with Michael De Angelis.

37. Council of Europe (1996): “The competent authorities should clearly state the consequences in the event of local authority insolvency”.

38. The economic upheavals and fiscal pressures of the early 1990s led to widespread deferral and cancellation of capital projects and infrastructure in all Bulgarian cities. Since then, Sofia has managed its budget prudently. As a capital city, however, it has unique advantages. Relatively debt free, the city has successfully entered the international bond market. Sofia issued a 50 million euro bond on 12 May 1999 (Ellis and Ionkova, 2004).


40. A narrow view would include only a limited range of public services such as police, drinking water and fire protection. The scope of protected essential services is likely to differ significantly across countries.
41. Variants of such limitations on attachment of subnational assets are found in many countries. An early example is a Swiss court judgment of 15 December 1881. Speaking to Wintertthur’s financial distress, the court held that taxation power and those buildings serving a public purpose were outside bankruptcy. Fasching (1983, p. 84) described the general principle of law that enforcement of private rights against public bodies is permitted as long as the existence and operation of the public entity is thereby not endangered.

42. For a more detailed discussion, see McConnell and Picker (1993).

43. Chapter 11 of the US Bankruptcy Code.


45. Chapter 9 of the US Bankruptcy Code contains a more appropriate definition of “insolvency” for municipalities, that is, “not paying its debts as they become due unless such debts are the subject of a bona fide dispute”.

46. Certain local government powers may be constitutionally protected and hence no interference is possible in insolvency. In the case of South Africa, strong intervention powers with decisions of elected officials granted by Municipal Financial Emergency Act called for a constitutional amendment.

47. See Hillhouse (1936) and De Angelis (2006). The political nature of subnationals adds complexity to defaults. According to Hillhouse (1936), the average local government default is highly complicated, since the subnational entity is a large aggregate of economic and social groups.

48. For a detailed account of state debt crises in the 1840s and resulting regulatory reforms, see Wallis (2004). Also see Scott (1974) for a history of state debt crises and repudiation in the United States. An interesting question is why such repudiation, the most extreme form of violating creditor rights, did not present a greater setback for the development of subnational capital markets. One should be cautious in extrapolating from the US experience. In the typical middle-income country today, repudiation could have longer-term negative consequences for the development of the capital market.

49. The subnational defaults during the Great Depression were exceptional insofar as widespread defaults were associated with an economywide downturn. Subsequently, subnational defaults in the United States have been much less frequent. The hard budget constraint as practiced in the United States should not be misconceived as a complete hands-off approach by the states. As illustrated by the example of New York City, states in the US do help restructure local government debt in exchange for fiscal reforms. Thus the hard budget constraint placed by states on local governments is more accurately described as conditional bailout.


52. The United States does not have a standard list of essential services. The judge interprets the legal principles and rules accordingly.

53. Jokay et al. (2004). In addition to the deterrence impact of the Act, the deficit grant program handled 700-1000 applications out of 3200 municipalities annually, which also served as a tool for bankruptcy prevention. Local governments must cut back discretionary activities and rationalize their expenditures to qualify for the grant program, ibid.

54. Hillhouse (1936, p. 428)

55. In German corporate bankruptcy, for example, wages, taxes and arrears to suppliers are in the first class, with shareholders in the second. In Japan, it is administrative claim holders, taxes and workers’ salary for three months prior to commencement of bankruptcy, other claim holders and finally shareholders. In China the order is, secured debt, bankruptcy expenses, staff wages and insurance, followed by taxes, unsecured debt and shareholders. The priority structure of US corporate bankruptcy places secured creditors first and unsecured creditors second. In the second class, the debt adjustment plan determines the order of repayment. Restructuring practice tends to give high priority to bondholders in the second class. We are grateful to Darshini Manraj from Doing Business, World Bank Group for sharing the information.
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56. From January 1972 to June 1984, municipalities only filed 21 petitions under Chapter 9. Between 1938 and 1991, 452 municipal bankruptcy cases were filed; 343 of those were filed before 1952 (Spiotto, 1984; McConnell and Picker, 1993, p. 471).


58. Meili (1885).

59. Prior to the Bankruptcy Reform Act of 1994, only general authorization to file for bankruptcy was required. In the past, inference from general statutes was sufficient. After the 1994 amendment, a direct and specific enabling piece of legislation is required.

60. See for example, Burnside (2005) on defining insolvency in general and Ianchovichina et al. (2006) for its application to the subnational context.


63. South Africa, Municipal Finance and Management Act, 2003, Chapter 13, Section 138 (a), (b), (c), (d), (e), (f), (g), (h), including failure to make payments as and when due (a), defaulting due to financial reasons (b), current expenditure exceeding current revenues plus available surpluses for at least two consecutive years (c), and operating deficit to revenues greater than 5 percent (d).

64. South Africa, Municipal Finance and Management Act, 2003, Chapter 13, Section 140 (1), (2), (3), (4).

65. Any single indicator or a subset of indicators in the first set of trigger suffices.


68. Ibid.

69. United States, Chapter 9 (109 (C) (2).

70. South Africa, Municipal Finance and Management Act, 2003, Chapter 13, Section 151 (a).

71. Law on Municipal Debt Adjustment, Law XXV, 1996. Four years after the Act, neither vendors nor banks petitioned for bankruptcy. According to Jokay et al. (2004), these creditors probably assumed that the local governments had few negotiable assets available and that operational cutbacks could not produce a cash flow sufficient for fully satisfying claims.


73. The stay on litigation is the most highly developed mechanism to prevent a rush to the courthouse. It is an authorization by the bankruptcy authority, freezing ongoing litigation and prohibiting future payments for some time. A more primitive instrument is the moratorium. The debtor unilaterally ceases to pay mature debt, while acknowledging the validity of the debt obligations. As a unilateral arbitrary act, the moratorium is at odds with a developed legal system. A standstill refers to a unilateral engagement by its creditors not to press their claims while the debt is restructuring, without intention to be legally bound, given that the subnational entity has suspended debt service payments.


75. Ibid. Note that in other countries, non-interference could be the direct result of constitutional protection for municipalities’ autonomy.

76. Ohio Code on Local Fiscal Emergencies (Title 1, Chapter 111): Financial emergency: (i) more than a 30-day default on a debt obligation, (ii) a failure to pay employees within 30 days, or (iii) a deficit or overdue amounts payable exceeding one-sixth of the previous year’s revenue.


78. Under the US Bankruptcy Code, the court has the power to “cram down” an agreement on a dissenting minority. The plan may still be confirmed if creditors in each class receive value under the plan equal to the amount of their claims, or if creditors whose claims are junior in priority receive nothing (Section 1129).

79. To make the MAC bonds more attractive, the state legislature declared the stock
transfer tax and the city sales tax to be state tax, and directed revenues from these be transferred to a fund under the MAC management and applied to the debt service and administration cost (Bailey, 1984).

80. In the United States, the Contracts Clause of the US Constitution (Article I. 10,1) puts the principle of pacta sunt servanda into constitutional form.

81. For more details and case histories, see McConnell and Picker (1993) and Kupetz (1995).

82. Ibid.

83. Law on Municipal Debt Adjustment, Law XXV, 1996, Chapter II, Section 9 (3) stipulates the financial trustee’s independence.

84. Law on Municipal Debt Adjustment, Law XXV, 1996, Chapter III, Section 23.

85. Law on Municipal Debt Adjustment, Law XXV, 1996, Chapter IV, Section 31. Assets are distributed to creditors in the following order: (1) regular personnel benefits including severance pay; (2) securitized debt (securitized by mortgage and other lines); (3) due to the central government; (4) social insurance debts, taxes, public contributions as tax; (5) other claims and (6) interest and fees on debt obligations continued during the bankruptcy proceeding.

86. South Africa, Municipal Finance and Management Act, 2003, Chapter 13, Section 155 (4).

87. The US experience suggests that public entities in financial distress will resort to using every possible technicality to challenge the validity of their outstanding obligations in the absence of a bankruptcy framework. Widespread challenges in a default wave of the nineteenth century led to the development of the bond council opinion, which certifies that the obligation is “legal, valid and enforceable”.

88. See Ter-Minassian and Craig (1997) for a summary of subnational borrowing control frameworks in over 50 countries, and how these control frameworks reflect “the individual country’s history, the balance of power among the different levels of government, macroeconomic and fiscal conditions, and the state of development of financial markets” (p. 169).

89. Even if used only rarely, subnational insolvency mechanisms shape bargaining power in voluntary restructuring negotiations. In the US, for example, the mere presence of Chapter 9 (the shadow of bankruptcy law) prods parties to voluntary agreement.

90. Many continental European countries have elaborate administrative mechanisms for supervising the actions of subnational governments, including their financial management.

91. In countries where reforms are proceeding on multiple fronts, the constitution itself can be subject to change, as illustrated by the constitutional amendments in South Africa to pave the way for establishing an insolvency framework.

92. Hunter v. City of Pittsburgh, 207 U.S. 161, 178 (1907) (holding that localities are no more than “convenient agencies for exercising such governmental powers of the State as may be entrusted to them”).

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World Bank (2005), Creditor Rights and Insolvency Standard. 
## Table 13A.1 Main elements of subnational insolvency procedures

<table>
<thead>
<tr>
<th>Insolvency triggers</th>
<th>Hungary</th>
<th>South Africa</th>
<th>United Statesa</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Invoice not disputed or paid within 60 days</td>
<td>1. Serious financial problems or anticipation of such problems</td>
<td>1. Debtor generally not paying due debts</td>
<td></td>
</tr>
<tr>
<td>2. Not paid a recognized debt within 60 days (Section 4 Law XXV (1996))</td>
<td>2. Persistent material breach of financial obligations (Chapter 13, Sections 136, 137, 138, 139)</td>
<td>2. Unable to pay debts as they become due</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Covered entities</th>
<th>Hungary</th>
<th>South Africa</th>
<th>United Statesa</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local governments</td>
<td>Only municipalities, not provinces</td>
<td>Municipalities (all political subdivisions and public agencies of a state) (Section 921)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Eligible filings</th>
<th>Hungary</th>
<th>South Africa</th>
<th>United Statesa</th>
</tr>
</thead>
<tbody>
<tr>
<td>Municipality or creditor through court petition</td>
<td>Provincial/ national executive decides based on insolvency triggers</td>
<td>Only the municipality itself (no involuntary filings) (Section 921)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Role of courts</th>
<th>Hungary</th>
<th>South Africa</th>
<th>United Statesa</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reviews petition, appoints financial trustee, approves reorganization/liquidation plan; broad role for financial trustee</td>
<td>Limited, elaboration and approval of plan in administrative branch; court approves stay and debt restructuring</td>
<td>Takes key procedural decisions, approves restructuring plan</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Hungary</td>
<td>South Africa</td>
<td>United States&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td>------------------</td>
<td>--------------------------------</td>
<td>----------------------------------------------</td>
<td>---------------------------------------------------</td>
</tr>
<tr>
<td><strong>Stay</strong></td>
<td>No enforcement outside the Act after commencement (Section 11)</td>
<td>Municipality may apply if unable to meet commitments, not automatic (Section 152)</td>
<td>Automatic with bankruptcy petition (Section 362; Section 922)</td>
</tr>
<tr>
<td><strong>Obtaining credit</strong></td>
<td>Possible if necessary to conclude a compromise (Section 34)</td>
<td>No specific provision in statute</td>
<td>Possible, if municipality could borrow money outside Chapter 9 (Section 364)</td>
</tr>
<tr>
<td><strong>Creditor majority</strong></td>
<td>Two-thirds of amount and one-half of eligible claims</td>
<td>Plan elaborated by Administrator and approved by Municipal Financial Recovery Service, not creditors</td>
<td>Chapter 11 requirements: two-thirds of amount, one-half of eligible claims (Sections 1124, 1126).</td>
</tr>
<tr>
<td><strong>Essential services</strong></td>
<td>Annex A: Mandatory Municipal Tasks (27 items)</td>
<td>Suspension of financial obligations only after provision for basic municipal services; term not defined in the legislation (Section 154)</td>
<td>Not defined, courts tend to construe narrowly</td>
</tr>
<tr>
<td><strong>Conditionality&lt;sup&gt;b&lt;/sup&gt;</strong></td>
<td>Substantial, in the hands of the receiver Approval by representative body generally required</td>
<td>Very strong, including dismissal of non-essential employees and liquidation of assets, determined by intervening authority</td>
<td>Limited, depends on bargaining outcome between creditors and municipality</td>
</tr>
</tbody>
</table>
### Table 13A.1 (continued)

<table>
<thead>
<tr>
<th>Priority of claims</th>
<th>Hungary</th>
<th>South Africa</th>
<th>United States&lt;sup&gt;a&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Wages</td>
<td>1. Secured creditors</td>
<td>1. Administrative claims</td>
<td></td>
</tr>
<tr>
<td>2. Secured claims;</td>
<td>2. Unsecured creditors pro rata (Section 155)</td>
<td>2. Secured creditors</td>
<td></td>
</tr>
<tr>
<td>3. CG crisis support</td>
<td></td>
<td>3. Unsecured creditors</td>
<td></td>
</tr>
<tr>
<td>4. Social security claims</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Other claims (Section 31)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Subnational autonomy</th>
<th>Crisis budget plan elaborated under supervision of financial trustee, who determines necessary assets</th>
<th>Strong powers of the Administrator, constitution amended to allow such strong intervention</th>
<th>No interference with any political or policy choices (Section 904). Requirement of state consent (Section 903)</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Dismissal</th>
<th>1. Filer not eligible</th>
<th>Not applicable, because within the purview of administration</th>
<th>“Bad faith” of debtor (Section 930):</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2. Council did not authorize (Section 8)</td>
<td></td>
<td>1. Unreasonable delay prejudicial to creditors</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>2. Failure to propose plan</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>3. Plan not accepted/denied</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>4. Material default on terms of plan</td>
</tr>
</tbody>
</table>

| Experience | 19 procedures, 100 out-of-court settlements | None (Chapter 13 entered into force in July 2006) | > 50 filings since 1945, substantial number of settlements and state procedures |

**Notes:**

a. This table covers only Chapter 9 of the US Bankruptcy Code, not fiscal and debt adjustments for local governments by states outside Chapter 9.

b. Adjustment measures that may be prescribed in exchange for a restructuring/debt relief.