Subnational Borrowing, Insolvency, and Regulation

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Subnational borrowing has become an important source of subnational finance in developing countries, owing to widespread decentralization of spending responsibilities, taxation power, and borrowing capacity to subnational governments. In particular, subnational governments have borrowed from the financial market to finance infrastructure, matching the maturity of debt with the economic life of the assets that the debt is financing. Furthermore, subnational revenue coming from taxation and fiscal transfers is small relative to the large infrastructure demands created by rapidly accelerating urbanization, which also necessitates subnational borrowing.

The subnational debt market in developing countries is also going through a notable transformation. Private capital has emerged to play an important role in subnational finance in countries such as Hungary, Mexico, Poland, Romania, and the Russian Federation. Subnational bonds increasingly compete with traditional bank financing. Both changes are facilitated by highly mobile international capital- and financial-market reforms in developing countries. Nonetheless, in many countries, only the most creditworthy subnational entities borrow. By the standards of developed countries, subnational bond markets remain tiny. In the United States,
US$400 billion subnational bonds are issued per year on average. In contrast, for example, 19 Mexican subnationals issued US$1.44 billion bonds from 2001 to 2005. The growth of the subnational bond market has been uneven, with wide swings since the 1990s.

With borrowing comes the risk of insolvency. The 1990s saw widespread subnational debt crises. To many observers, runaway provincial debt in Mendoza and Buenos Aires was a major factor behind Argentina's sovereign debt default in 2001. Brazil experienced two subnational debt crises following the early one in the 1980s. The 1995 Tequila crisis in Mexico exposed the vulnerability of subnational debt to the peso devaluation and led many Mexican subnationals into debt crisis. In Russia, at least 57 of 89 regional governments defaulted from 1998 to 2001.

Even without explicit defaults or debt crises, fiscal stress and implicit liabilities from borrowing are a real concern. 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. Subnational governments in Colombia, Hungary, and South Africa experienced fiscal stress in the 1990s. Although subnational governments in China cannot borrow directly from the financial market, they do borrow indirectly off budget to finance infrastructure through public utility companies, special-purpose vehicles, and urban development investment corporations. The implicit subnational debt is a real concern to the central government.

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, garbage collection, and schools were cut back. Maintenance on bridges and roads was postponed. Many capital projects were delayed or canceled (Bailey 1984). Beyond local service delivery, subnational insolvency may impede the growth of subnational credit markets and curtail fiscal space for infrastructure financing. In South Africa, in developing a unifying legal framework for subnational finance after the fall of apartheid, the national government viewed a lack of insolvency procedures as an impediment to the development of a competitive and diversified credit market for municipal finance (South Africa National Treasury 2001: 192–93). In Romania, the capital market is reluctant to extend maturity and lower spreads to subnational borrowers because of the absence of a collective framework for insolvency (Liu and Waibel 2008). Systemic subnational fiscal stress and insolvency also threaten macroeconomic and financial stability.

The resolution to the threat of subnational insolvency should not lie in prohibiting subnational borrowing altogether. The benefits from subnationals' access to the financial market are numerous. Yet subnational
borrowing, left unregulated, entails the risk of insolvency, which threatens local service delivery as well as macroeconomic and financial system stability. The way forward is to develop a regulatory framework that can help expand subnational borrowing, strengthen subnational fiscal discipline, and manage potential risks while at the same time supporting reforms in the intergovernmental fiscal system and financial markets for more efficient use of capital. The primary focus of this chapter is on the regulatory framework for subnational borrowing; the reforms of intergovernmental fiscal systems and the structure of financial markets are beyond the scope of the chapter.

The rest of the chapter is organized as follows. The next section analyzes benefits and risks of subnational borrowing. The following section presents the motivation and rationales for regulating subnational borrowing. The chapter then summarizes regulatory frameworks for subnational borrowing based on cross-country experiences. First, it focuses on ex ante regulation, specifying purpose, types, amount, and procedures of borrowing. Then, it examines ex post insolvency mechanisms that enforce and complement the preventive rules and discipline borrowers and creditors. The final section concludes.

Benefits and Risks of Subnational Borrowing

Allowing subnational governments to access the financial market brings about several principal benefits. First, it enables subnational governments to expand fiscal space for infrastructure. Pressing demands for infrastructure—particularly urban infrastructure—will continue to rise as cities strive to be successful conduits for innovation and growth while absorbing a massive influx of rural population. The unprecedented scale of urbanization in developing countries requires large-scale infrastructure financing much beyond fiscal transfers and subnational own-tax revenues.10

Second, subnational borrowing finances infrastructure more efficiently and equitably. Infrastructure investment benefits future generations, who should therefore also bear the cost. Maturity of debt should match the economic life of the assets that the debt is financing. Amortization of the liabilities should be matched by depreciation of the assets being financed. Matching asset life to maturity is sound public policy because these infrastructure services can be paid for by the beneficiaries of the services.11

Third, allowing subnational governments to access the financial market exposes subnationals to market disciplines and reporting requirements, hence strengthening fiscal transparency, sound budget and financial management, and good governance. Rigorous creditworthiness assessment by
independent credit rating agencies is a precondition for accessing the capital market.\textsuperscript{12} It requires disclosure of independently audited public financial accounts, thereby strengthening the role of markets in fiscal monitoring and surveillance. The promotion of credit ratings is an important step in the development of a broad-based subnational credit market. Credit ratings will also have a strong bearing on the dynamics of fiscal and financial risks at the subnational level. They help national and subnational governments manage debt rollover risks associated with interest and exchange rates and maturity structure,\textsuperscript{13} as well as contingent liabilities such as locally managed infrastructure contracts and off-budget activities.

Fourth, expanding subnational borrowing facilitates the deepening of financial markets. A competitive subnational credit market with numerous buyers and sellers and financial options, such as bond financing competing with bank lending, can help diversify subnational credit markets and lower borrowing cost.\textsuperscript{14} In several advanced countries, the subnational bond market represents a significant portion of the debt market. The United States has the largest subnational bond market. Individual investors are the largest holders of U.S. subnational bonds, followed by mutual funds, bank trust accounts, banks, insurance companies, and corporations (Maco 2001). Greater mobility of international capital and diversification of financial instruments have contributed to the rise of subnational bond markets in emerging markets.

Notwithstanding the benefits, risks to subnational borrowing exist in the absence of an effective regulatory framework, as manifested by recent subnational fiscal stress and debt crises in countries such as Brazil, India, Mexico, and Russia.\textsuperscript{15} Understanding the root causes of these fiscal and debt crises helps develop an effective subnational regulatory framework that can minimize the occurrences of systemic crises. Although China and India, for instance, have not yet experienced explicit and systemic subnational insolvency,\textsuperscript{16} the reported fiscal stresses by many lower levels of subnational governments and implicit liabilities share similarities with other emerging economies.\textsuperscript{17}

Although expenditure-revenue imbalances may cause the development of subnational fiscal stress, the regulatory framework for borrowing profoundly affects the fiscal sustainability of a subnational government, because accumulation of the fiscal deficits is feasible only when they have been financed.\textsuperscript{18} Unregulated subnational borrowing grew rapidly in countries such as Hungary and Russia in the 1990s, contributing to subnational fiscal stress. Borrowing by subnational governments in Hungary and Russia was also facilitated by decentralization, which granted substantial autonomy
in debt financing to subnational governments but failed to impose hard budget constraints.

Unregulated borrowing is particularly risky in an uncertain macroeconomic environment, as illustrated by the subnational debt crises in Russia. Unfettered market access by subnational borrowers, especially in newly minted, speculative, and unregulated security markets, can outpace the development of sound revenue streams and a regulatory framework. In particular, foreign borrowing in an uncertain macroeconomic environment with the risk of currency speculation can be costly (see Alam, Titov, and Petersen 2004). Because of the effect of macroeconomic policies, including interest rates and exchange rates on subnational fiscal profiles, the rating of the sovereign typically binds the ratings of its subnational entities.19

The fiscal deficit itself may not be a problem if borrowing finances capital investment and economic growth.20 However, subnational governments borrowed heavily to finance substantial operating deficits in countries such as Hungary, India, and Russia, leading to unsustainable debt paths.21 Borrowing for operating deficit violates the golden rule of public finance. In India, much of the growth in fiscal deficits of states in the late 1990s was driven by borrowing to finance revenue deficits; for example, at the height of crisis, in some states more than 70 percent of new borrowing was merely to refinance existing debt.22

Furthermore, debt profiles of subnational governments can have inherent rollover risks, which would be exacerbated by macroeconomic and financial shocks. Before the macroeconomic crisis in Mexico in the mid 1990s and in Russia in the late 1990s, subnational governments there had risky debt profiles—short maturities, high debt service ratios, and variable interest rates. The macroeconomic crisis exposed the vulnerability of fiscal positions of subnational governments and triggered widespread subnational debt crises.23

Last but not least, contingent liabilities were a major source of fiscal deterioration in many developing countries, quietly eroding the financial health of subnational governments, thereby leading to the sudden onset of fiscal crises without warnings. Among Indian states in the late 1990s, special-purpose vehicles became a convenient way of circumventing tight budgets. Guarantees by states to support market borrowing of loss-making public sector undertakings, a contingent liability, grew rapidly. Early episodes of subnational debt development in the United States and developing countries today share striking similarities. Before the financial crisis in the early 1840s, many U.S. states aggressively sought debt financing of their large infrastructure projects. Several states owned public banks that participated
in financing of infrastructure projects. Some infrastructure projects were developed by public enterprises created and owned by states; others were financed by states but owned and operated by private entities. States experimented with a variety of ways of financing investments. Some used taxless finance, which did not require raising tax immediately but resulted in taxpayers assuming contingent liabilities.24

In addition to off-budget liabilities of special-purpose vehicles and opaque transactions between subnational governments and their enterprises, there are other sources of hidden or contingent liabilities that are not reported in or captured by published fiscal accounts. Growing subnational civil-servant pension liabilities under the pay-as-you-go system have been a serious and growing threat to subnational financial health in Brazil and India. Nonperforming assets of banks owned by subnational governments in Argentina and Brazil partly explained subnational debt crises in the 1990s. Furthermore, the cash-reporting system systematically underestimates the financial liabilities of subnational governments in many developing countries. The cash-accounting system does not capture arrears to suppliers, contractors, or central government agencies or delayed payments of civil-servant wages and pensions.25

Subnational borrowing behavior is strongly influenced by the design of the intergovernmental fiscal system and the structure of financial markets. Market participants may tolerate unsustainable fiscal policy of a subnational government if the history backs their perception that the central government implicitly guarantees the debt service of the subnational government (Ianchovichina, Liu, Nagarajan 2007). Imprudent lending based on anticipated or implicit guarantees from the central government contributed to the subnational fiscal crises in Hungary, Mexico, and Russia. Furthermore, lending to subnational governments was dominated by public banks in countries such as Brazil,26 Hungary, and India, which have weak incentives to price returns and risks.

Soft budget constraints, a key aspect of fiscal incentives, allow subnational governments to live beyond their means, negating competitive incentives and fostering corruption and rent-seeking.27 According to Webb (2004), subnational debt markets have three important agency problems:

- Subnational borrowers as agents have an incentive not to repay their lenders as principals if they anticipate bailouts.
- Subnational borrowers as agents have an incentive not to reveal certain characteristics about themselves to lenders as principals, resulting in adverse selection.28
Banks are implicit agents of the nation, entrusted to maintain the nation’s payment system and creditworthiness, and they often abuse this trust by lending to uncreditworthy subnational governments with the expectation of bailouts by the national government in case of trouble.

The incidence of these agency problems varies considerably depending on the structure of each country’s subnational debt market.

**Rationales for Regulating Subnational Borrowing**

The development since the late 1990s of regulatory frameworks for subnational borrowing in developing countries is the direct result of, and response to, subnational fiscal stress and debt crises. Regulatory frameworks for subnational borrowing should contain two parts: first, ex ante control, regulation of borrowing, and monitoring of the subnational fiscal position; second, ex post debt restructuring in the event that subnational governments become insolvent. The regulatory frameworks in many countries are still evolving, and the pace of putting together a full range of regulatory elements varies. Furthermore, regulatory frameworks are inseparable from the reform of intergovernmental fiscal systems and financial markets because they profoundly shape incentives for subnational governments to pursue sustainable fiscal and debt policies and for creditors to price returns and risks appropriately.

Ex ante borrowing regulation and ex post insolvency mechanisms complement each other. Insolvency mechanisms increase the pain of circumventing ex ante regulation for lenders and subnational borrowers, thereby enhancing the effectiveness of preventive rules. Without an ex post insolvency mechanism, ex ante regulation can easily turn to excessive administrative control and game playing between the central and subnational governments. Overreliance on ex ante regulations, including central government approval of individual loans, limits the role of markets in monitoring subnational borrowing and debt. In Canada and the United States, markets play a vital role in the surveillance of subnational borrowing. Although, realistically, developing countries cannot yet rely heavily on markets for monitoring subnational borrowing, developing countries should aim at carefully fostering the role of the market in the design of regulatory frameworks.

Subnational borrowing legislation functions as a commitment device to allow subnational governments to access the financial market within a common framework. An individual subnational government may adopt unsustainable fiscal policies for a variety of reasons. Inherent incentives
exist for a subnational government to free-ride—it bears only part of the cost of unsustainable fiscal policies, but it alone receives all benefits. Realizing these benefits depends on good fiscal behavior by most of the other subnational governments. So collectively governments benefit from a system of rules to discourage such defection and free-riding. The commitment device controls and coordinates subnational governments across space in various localities and across time to commit future governments to a common borrowing framework (Webb 2004).

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

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

The need for a collective framework for resolving debt claims is even greater in the context of subnational insolvency. Conflicts exist not only between creditors and debtor, but also among creditors. For instance, individual creditors often demand preferential treatment and threaten to derail debt restructurings voluntarily negotiated between a majority of creditors and the subnational debtor (the so-called holdout problem). Creditors’ remedies under contract law (instead of insolvency mechanisms) are effective to enforce discrete unpaid obligations, but they fail if there is a general inability to pay. Individual ad hoc negotiations are costly, impracticable, and harmful to the interests of a majority of creditors. The holdout problem is not as serious if debts are concentrated in a few banks. However, a collective framework for insolvency restructuring takes on more importance as the subnational bond markets develop—with thousands of creditors.
The motivations for developing regulatory frameworks differ significantly across countries, reflecting a country’s political, economic, and legal and historical context, which in combination with triggering events results in country-specific motivations. These differences affect the entry point for reform, the framework’s design, and its relation to subnational borrowing legislation.

For example, although the U.S. municipal bankruptcy framework offers a valuable reference for other countries, the framework itself cannot be copied without care. Chapter 9 of the U.S. Bankruptcy Code was conceived with the narrow objective of resolving the holdout problem, against the background of a mature intergovernmental fiscal system and a market-oriented financial system. In countries where the intergovernmental systems are still evolving or where lending to subnational governments is dominated by a few public institutions, the development of a subnational insolvency mechanism must be sequenced with other reforms. The unique federal structure of the United States also profoundly influences the specific design of Chapter 9—for example, with respect to the role of federal courts in the debt adjustment plan of insolvent municipalities. Because the insolvency mechanism needs to define the respective role of different branches and tiers of the government, a country’s political and economic history plays a key role in shaping the design of the insolvency mechanism.

Frameworks for Subnational Borrowing:
Ex ante Regulation

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

Brazil has substantially strengthened ex ante regulations in response to repeated waves of subnational debt crises. The federal government bailed out subnational debtors in earlier crises, but the resolution of the third debt crisis was conditioned on states undertaking difficult fiscal and structural reforms. The avoidance of unconditional bailouts in 1997 was to resolve moral hazard. The strengthened ex ante borrowing regulations
were embedded in the debt restructuring agreements between 25 states and the federal government in 1997, sanctioned by legislation. The Fiscal Responsibility Law in 2000 consolidated various pieces of legislation into one unifying framework. In Mexico, a new borrowing framework was developed in 2000 to address the subnational debt crisis triggered by the financial crisis in 1994 and 1995. Compared with the situation in Brazil and Mexico, subnational debt stress in Colombia was much less severe. But the country developed a borrowing framework, as defined by various pieces of legislation, including Law 358 in 1997, Law 617 in 2000, and more recently the Fiscal Transparency and Responsibility Law in 2003. To avoid a subnational debt crisis as experienced by other countries in the region, Peru, while embarking on decentralization in 2002, developed subnational borrowing rules: the Fiscal Responsibility and Transparency Law in 2003 and the General Debt Law in 2005. In India, after the state fiscal crises in the late 1990s, the 12th Finance Commission put forward recommendations on fiscal rules and targets, as well as incentives for states to comply with the rules and targets. Several key elements in ex ante borrowing regulation across several countries can be surmised on the basis of Liu and Waibel (2006). First, borrowing is allowed only for long-term public capital investments. Some European countries, such as Germany and the United Kingdom, have enacted fiscal rules of a balanced budget net of public investment (the “golden rule”). This element links back to the earlier idea that only such borrowing is beneficial (and may be in the interest of future generations). A number of middle-income countries, such as Brazil, Colombia, India, Peru, Russia, and South Africa, have recently adopted the golden rule. Second, the frameworks specify limits on key fiscal variables, such as fiscal deficit, primary deficit, debt service ratios, and ceilings on guarantees issued. In India, a state with a debt service ratio exceeding 20 percent is classified as having a debt stress status, triggering the central government’s close monitoring of additional borrowing by the state. As recommended by the 12th Finance Commission, fiscal responsibility legislation is mandatory for all states, with the revenue deficit to be eliminated and the fiscal deficit to be reduced to 3 percent of gross state domestic product by fiscal year 2009. Colombia sought to limit subnational debt to payment capacity (Law 358 in 1997 and the Fiscal Transparency and Responsibility Law in 2003). A traffic-light system was established to regulate subnational borrowing. Subnational governments rated in the red-light zone are prohibited from borrowing, and those in the green-light zone are permitted to borrow. The red-light zone is defined as the ratio of interest to operational savings greater than 40 percent.
and the ratio of debt stock over current revenues greater than 80 percent. In Brazil, the debt restructuring agreements between the federal government and the states established a comprehensive list of fiscal targets—debt-to-revenue ratio, primary balance, personnel spending as share of total spending, own-source revenue growth, and investment ceilings—as well as a list of state-owned enterprises or banks to be privatized or concessioned. In the United States, the rules governing subnational borrowing depend on the type of debt issued, the revenue used to service the debt, and the type or form of government issuing it. These rules vary from state to state. Markets play a vital role in fiscal surveillance (Liu and Wallis 2008).

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

Furthermore, fiscal transparency is increasingly becoming an integrated part of fiscal frameworks. Transparency includes having an independent audit of subnational financial accounts, making periodic public disclosures of key fiscal data, exposing hidden liabilities, and moving off-budget liabilities on budget. In India, several reforming states have started to move the off-budget liabilities onto the budget and have established the measure of consolidated fiscal deficit beyond the conventional cash deficit; the reported fiscal deficit does not capture the financing deficit of large public sector undertakings, which implicitly are states’ liabilities.

In Brazil, the accrual accounting method for all levels of the government eliminates an important source of hidden liabilities: arrears. Moreover, article 48 of Brazil’s Fiscal Responsibility Law (2000) enshrines fiscal transparency as a key component of the new framework. Proposals, laws, and accounts are to be widely distributed, including through the use of electronic media (all reports are made available on the Web site of the Ministry of the Treasury). Article 54 requires that all levels of governments publish a quarterly fiscal management report that contains the major fiscal variables and
indicates compliance with fiscal targets. Pursuant to article 57, this report is to be certified by the audit courts.

Ex ante regulation may not be purely on the borrower side. To improve fiscal transparency, Mexico introduced a credit rating system for subnational governments. Although subnational participation in the credit rating is voluntary, the requirements of the capital-risk weighting of bank loans introduced in 2000 and of loss provisions introduced in 2004 aim at imposing subnational fiscal discipline through the market pricing of subnational credit. In Colombia, the Fiscal Transparency and Responsibility Law (2003) also tightened the regulations on the supply side. Lending to subnationals by financial institutions and territorial development institutions must meet the conditions and limits of various regulations, such as Law 617 and Law 817. Otherwise, the credit contract is invalid and borrowed funds must be restituted promptly without interest or any other charges.

Regulatory Frameworks for Subnational Borrowing: Insolvency Mechanisms

Ex post regulatory regulation—that is, subnational insolvency mechanisms—deals with insolvent subnational governments. Although ex ante regulation helps minimize the risk of defaults, it cannot prevent all defaults. Defaults may simply arise because of a subnational’s own fiscal mismanagement, because of macroeconomic or exogenous shocks, or because of both. Several key design considerations arise concerning insolvency procedures—namely, the fundamental differences between public and private insolvency, the choices between judicial or administrative approaches, and the operation of the insolvency procedure itself. The central question is the resolution of the differing interests between creditors and the insolvent subnational borrower.

The public nature of the services provided by governments explains the fundamental difference between public insolvency and the bankruptcy of a private corporation. This factor leads to the basic tension between protecting creditors’ rights and maintaining essential public services. Creditors’ remedies against defaulting subnationals, as opposed to corporations, are narrower, leading to greater moral hazard (strategic defaults). Whereas a corporation is able to self-dissolve, this route is barred for subnational governments. When a private corporation goes bankrupt, all 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. In the case of subnational insolvency, the insolvency mechanism is generally a reorganization type, not liquidation of all assets.
There are two alternative approaches to subnational insolvency: the judicial and the administrative. Various hybrids also exist. Judicial procedures place courts in the driver's seat. Courts make key decisions to guide the restructuring process, including when and how a municipal insolvency is triggered, and to guide a priority structure for allocating assets among competing claims. Because the debt discharge is highly complex, the judicial approach has the advantage of neutralizing political pressures during the restructuring. However, because mandates for budgetary matters lie with the executive and legislature in many countries, the courts’ ability to influence fiscal adjustment of subnational entities is extremely limited. 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 choice of approach varies across countries, depending on the history, political and economic structure, and motivation for establishing an insolvency mechanism. In Hungary, a desire to neutralize political pressure for bailing out insolvent subnational governments favored the judicial approach. South Africa’s legal framework for municipal bankruptcy is a hybrid, blending administrative intervention with the role of courts in deciding debt restructuring and discharge. It uses sequential administrative interventions in the event of municipal financial distress: an early-warning system consisting of various indicators, intervention by provincial governments, and then intervention by the central government. Meanwhile, municipalities in South Africa can appeal to courts for staying, restructuring, or discharging debt. In Brazil, after having bailed out insolvent subnational entities in the two earlier debt crises, the federal government chose an administrative approach in dealing with the third debt crisis. The central government intervened directly in fiscal and debt adjustment, imposing difficult structural reforms to tackle the root causes of fiscal insolvency, instilled fiscal transparency, and essentially imposed a fiscal and debt adjustment package that was based on reform conditions.

The United States has both judicial and administrative approaches. In response to widespread municipal defaults during the Great Depression, the U.S. Congress adopted a municipal insolvency law in 1937, known today as Chapter 9 of the U.S. Bankruptcy Code. The primary aim of this legislation was to deal with the holdout problem. The mandamus writ was recognized as useful for enforcing unpaid discrete obligations; it is ineffective if the subnational is generally unable to pay. Chapter 9 is a debt restructuring mechanism for political subdivisions and agencies of U.S. states. It provides the procedural machinery whereby a debt restructuring plan acceptable to a majority of creditors
can become binding on a dissenting minority. Only debtors may file for Chapter 9. Many states have adopted their own frameworks for dealing with municipal financial distress, for two reasons. First, municipalities are political subdivisions of the states. Second, state consent is a precondition for municipalities to file for Chapter 9 in federal court. That requirement is one instance of how the U.S. constitution reserves control over municipalities to states. Moreover, federal courts may not exercise jurisdiction over policy choices and budget priorities of the debtor. No uniform approach exists across states: 21 of the 50 states give blanket consent, 3 states attach important conditions, and 27 states grant permission on a case-by-case basis (see Laughlin 2005). New York City’s bankruptcy in 1975 and Ohio’s early-warning system monitoring of the financial health of municipalities are two prominent examples of direct state involvement in resolving financial distress.

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

Specific legal definitions serve as procedural triggers for initiating insolvency proceedings. While the United States and Hungary define insolvency as inability to pay, South Africa chose one set of triggers for serious financial problems and another for persistent material breach of financial commitments. In all three countries, the bankruptcy code empowers the bankruptcy court to dismiss petitions not filed in good faith. Because bankruptcy procedures have the power to discharge debt, a subnational entity may file purely for the purpose of evading debt obligations. The U.S. Bankruptcy Code erects obstacles to municipal filing beyond those faced by private debtors, thereby discouraging strategic municipal bankruptcy filings.

Who can file for bankruptcy? The class of eligible filers differs across countries. In the United States, under section 109(c)(2) of Chapter 9, only the municipality can file for bankruptcy, conditional on being insolvent, having worked out or attempted to work out a plan to deal with its debts, and having been authorized by the state to file for bankruptcy. The more stringent requirement for filing under Chapter 9, as compared with filing under Chapter 11, is due to the constraint set by the U.S. constitution. A creditor cannot bring a municipality into a federal court against its will, based on the constitution’s 11th amendment. Like Chapter 9, Schwarcz’s (2002) model law for subnational insolvency allows only municipalities
to file. In South Africa, under chapter 13, section 151(a), of the 2003 Municipal Financial Management Act, any creditor can trigger the insolvency procedure. Similarly, in Hungary, a creditor can petition the court if a municipality is in arrears for more than 60 days.

Fiscal adjustment and consolidation are preconditions for financial workouts. Often a subnational government’s own fiscal mismanagement is the root cause of insolvency. Even when subnational insolvency is triggered by macroeconomic shocks, such as a sharp rise in real interest rates through a currency crisis, fiscal adjustment is inherent to any insolvency procedures. Ianchovichina, Liu, and Nagarajan (2007) present a framework for analyzing subnational fiscal adjustment. Similar to fiscal adjustment by central governments, real interest rates, economic growth of the subnational economy, and the subnational government’s primary balance determine subnational debt sustainability.

They argue, however, 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 fiscal system. Unable to issue their own currency, subnational governments cannot use seigniorage finance. They cannot freely adjust their primary balance because of legal constraints on raising their 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 economic growth and fiscal health of the subnational economy are designed largely or exclusively by the central government.

Even in a decentralized system such as that in the United States, where subnational governments have broad freedom to control expenditures, raise revenues, influence their local economic growth, and affect the interest rate spread (which links to the creditworthiness of each subnational entity) in a competitive capital market, fiscal adjustment often requires difficult political choices of cutting expenditure and raising revenues.

Debt restructuring lies at the heart of any insolvency framework. In administrative interventions, the higher level of government often restructures subnational debt obligations into longer-term debt instruments. The 1997 debt agreements between the Brazilian federal government and the 25 states, though strengthening ex ante regulations, might at the same time be seen as an ex post intervention, because the agreements were imposed on a case-by-case basis as a condition of debt restructuring.
The debt discharge, however, is a major departure from the principle that contracts ought to be fulfilled. Discharges are typically limited to judicial mechanisms. A mature and independent judicial mechanism is viewed as well placed to ensure the fairness of discharges. Ex post modification of contracts needs to be tightly circumscribed. If creditors feel that they are treated unfairly, there is a substantial risk that they will stop lending. Perceptions of what is equitable are likely to differ across countries because distributional judgments are involved.

Debt restructuring and debt discharge are complex. But one basic question is who holds the cram-down power when both sides fail to reach an agreement. Under Chapter 9 of the U.S. Bankruptcy Code, municipal debtors propose the debt adjustment plan, which may modify the terms of existing debt instruments. Such adjustment plans may be adopted over the objection of holdout creditors. Chapter 9 incorporates basic Chapter 11 requirements: at least one impaired class of claims approves the plan, and secured creditors must receive at least the value of the secured property. Unsecured creditors thus often lose out.

In Hungary, the Debt Committee is chaired by a court-appointed independent financial trustee. Under the Law on Municipal Debt Adjustment (Law XXV, 1996), the committee prepares a reorganization plan and debt settlement proposal. The plan and proposal are adopted by majority vote of the committee and are 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 (see Chapter III, section 23, of the Law on Municipal Debt Adjustment). The law also stipulates the priority of asset distributions. If disagreements arise on distribution, the court makes the final decision, which cannot be appealed (see Chapter IV, section 31).

South Africa’s legislation stipulates that debt discharge and settlement of claims must be approved by the court. The settlement of claims takes the following order: (a) secured creditor, provided that the security was given in good faith and at least six months before the mandatory intervention; (b) preferred claims, as provided by the 1936 Insolvency Act; and (c) non-preferential claims (see Chapter 13, section 155(4), of the Municipal Finance and Management Act, 2003).

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 the subnational debtor in financial distress. Insolvency law preserves the legal order by superseding contractual violations with a new legal act. A procedure for
Subnational insolvency recognizes that resolving financial distress through mechanisms guided by law is preferable over muddling through repeated, costly, and often unsuccessful negotiations.

The maturity of the legal system influences the choices of procedure. Implementation of insolvency procedures—in the corporate and the subnational contexts—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, buttressing concerns on lack of substantive restructuring expertise (Gitlin and Watkins 1999).

Conclusions

Many developing countries will continue the decentralization process and reform their intergovernmental fiscal system over the next two decades. At the same time, large infrastructure demand at the subnational level will continue. As a result of these two trends, subnational borrowing legislation is likely to figure high on the policy agenda. In developing subnational borrowing legislation, experience in other countries offers valuable lessons. While indicating workable solutions, other countries’ experience also highlights potential pitfalls in the design of ex ante and ex post subnational borrowing frameworks.

A subnational borrowing framework has several complementary components. First, access to financial markets depends on fiscal transparency. Timely availability of comprehensive fiscal information requires disclosure and independent audits of the subnational entity’s accounts, including of all special-purpose vehicles. Second, ex ante rules specify the type and purpose of borrowing, the procedural steps for contracting debt, and any limitations on borrowing. Third, ex post insolvency mechanisms are essential to the borrowing framework. Even if rarely invoked, they shape expectations about defaults and allow and encourage the stakeholders to resolve subnational financial distress efficiently.

Subnational borrowing behavior is strongly influenced by the design of the intergovernmental fiscal system and the structure of financial markets. Market participants may tolerate unsustainable fiscal policy of a subnational
government if history backs their perception that the central government implicitly guarantees the debt service of the subnational government. The soft budget constraint embedded in the intergovernmental fiscal transfers system can undermine the effectiveness of borrowing regulations. The principal-agent problem is particularly potent for subnational borrowing, and the threat of the soft budget constraint negates competitive incentives and fosters corruption and rent-seeking. The threat can be exacerbated by banks acting as implicit agents of the nation if they abuse this trust by lending to uncreditworthy subnational governments with the expectation of bailouts in case of trouble.

Introducing transparency into the subnational fiscal management system and subnational borrowing ought to be a policy priority. Off-budget liabilities, despite their potential to finance urgently needed infrastructure, present tremendous fiscal risks. Despite different local conditions, a clear and transparent subnational borrowing framework could substantially lessen those risks in a range of middle-income countries while opening access to financial markets. Such orderly borrowing helps expand fiscal space for infrastructure investment in a world of accelerating urbanization. Financial markets then play a greater role in intermediating savings and investments.

Even in countries with a general ban on subnational borrowing, subnational governments often resort to off-budget borrowing to accumulate implicit debt. The inefficacy of outright bans on subnational borrowing, coupled with lax enforcement and little monitoring, is now clear. A related macroeconomic concern is the level of implicit liabilities at the subnational level. Together with a lack of transparency and opaque accounting frameworks, this situation is a recipe for subnational financial distress.

Like ex ante regulation, subnational insolvency procedures invariably need to be adapted to country-specific circumstances. Although Chapter 9 of the U.S. Bankruptcy Code may serve as a starting point, it will rarely be a model to be copied one for one. First, Chapter 9’s focus is the holdout problem; middle-income countries considering the introduction of subnational insolvency mechanisms might have different policy priorities in ex post resolution of subnational financial distress. Second, peculiarities of each country’s intergovernmental fiscal system warrant special attention. Third, not only does introduction of an insolvency mechanism require sequencing with other reforms; it also requires bankruptcy expertise and independent courts if a judicial approach is preferred. The entry point for reform, including the maturity of the legal system, determines the choices of procedure.
Insolvency mechanisms encourage voluntary bargaining in the shadow of bankruptcy; they anchor expectations about risks and rewards of subnational borrowing. Insolvency is above all a distributional struggle for a dwindling pool of revenues. In such circumstances, clear and predictable rules on priority of repayment ease the struggle and allow faster resolution of financial distress. They increase the pain of circumventing ex ante rules and thereby enhance the effectiveness of preventive rules. Without ex post insolvency mechanisms, ex ante regulation can all too easily turn into excessive administrative control.

A comprehensive subnational borrowing framework also accomplishes several macroeconomic objectives. Together, ex ante regulation and ex post regulation, in conjunction with fiscal transparency, minimize systemic risk of subnational borrowing. They lessen the incentives for individual subnational borrowers to free-ride on shared national creditworthiness and to incur unsustainable debt levels. If well designed, they also allow for more efficient access to credit and resource allocation.

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

Subnational borrowing regulations alone are not sufficient for sustainable subnational finance and the emergence of competitive subnational credit markets. Broader institutional reforms need to proceed in tandem. Foremost is the maintenance of macroeconomic stability and improved country credit ratings, because the sovereign rating puts a ceiling on the rating of subnational governments, thus affecting the cost and maturity of subnational borrowing. Moreover, the intergovernmental fiscal system underpins the fundamentals of the subnational fiscal path. Without increased fiscal autonomy and greater own-source revenues, subnational governments will rarely be in a position to borrow sustainably on their own. The hard budget constraint designed in the insolvency proceeding
can be offset by the soft grant transfers. Furthermore, the development of competitive financial markets, by broadening the investor base, will increase the availability of capital. Competition among lending instruments such as bank lending and bond finance is also likely to lower borrowing costs. Introducing competition is particularly relevant for countries where a small number of public institutions dominate subnational lending. To maintain investor confidence, securities law and antifraud enforcement need to reach international standards.

Notes

This chapter draws on work as reflected in Liu and Waibel (2006, 2008) and Liu (2008). The findings and conclusions expressed herein are those of the authors. They do not necessarily reflect the views of the World Bank, its affiliated organizations, or those of the executive directors of the World Bank or the governments they represent.

1. For analysis on decentralization in developing countries, see Shah (2004). The term subnational refers to all tiers of government and public entities below the federal or central government. Subnational entities include states or provinces, counties, cities, towns, public utility companies, school districts, and other special-purpose government entities that have the capacity to incur debt.

2. The term financial market refers to both the banking system and the bond market.

3. Public institutions continue to dominate subnational lending in a number of countries, such as Brazil and India.

4. On January 1, 2006, subnational bonds outstanding reached US$2.26 trillion. This figure represents close to 10 percent of the U.S. domestic bond market and 26 percent of all U.S. public sector bonds (authors’ calculation based on World Bank 2006). The figure of US$400 billion issues is from Petersen (2005).


6. A subnational entity unable to pay its debts as they fall due is insolvent. Over and above default (failure to pay according to the terms of the debt instrument), insolvency is characterized by a genuine, and not merely temporary, shortfall of resources to service the entire subnational debt stock.

7. For the case of Argentina, see Hochman (2002); for Brazil, see Dillinger (2002); for Mexico, see Barrientos (2002); and for Russia, see Popov (2002). For a summary of Brazil, Mexico, and Russia, see Liu and Waibel (2006).

8. For an account of fiscal stress in Indian states, see Ianchovichina, Liu, and Nagarajan (2007). For the fiscal situation in China, see Liu (2008); for Colombia, see Liu and
Waibel (2006) and Webb (2004); for Hungary, see Jókay, Szepesi, and Szmetana (2004); and for South Africa, see Glasser (2005), Liu and Waibel (2008), and South Africa National Treasury (2001).

9. For example, Brazil’s macroeconomic crises in the 1980s and 1990s were closely related to subnational insolvency (Dillinger 2002). In India, persistent imbalance in public finance is widely viewed as the most important challenge in macroeconomic management. About half of the general government deficit comes from states’ fiscal deficits.

10. For example, China has been investing about 10 percent of its gross domestic product (GDP) annually in infrastructure since the 1990s, and subnational governments have taken up a large share of infrastructure investments, particularly in urban infrastructure. The majority of financing comes from proceeds from land leasing and public bank lending securitized on property and land valuation. Public infrastructure investment by Indian states has stayed below 3 percent of their gross state domestic product since the 1990s (Liu 2008). In Brazil, public investment by the general government (including for infrastructure) shrank about 50 percent between 1998 and 2006 to about 2 percent of GDP. In the United States, subnational infrastructure is financed dominantly by bonds raised in the private capital market (Liu and Wallis 2008).

11. However, borrowing to finance infrastructure can burden future generations with debt without corresponding benefits when infrastructure is badly planned and managed.

12. For a review of how international rating agencies Standard & Poor’s, Moody’s, and Fitch access subnational creditworthiness, see Liu and Tan (2008).

13. **Rollover risk** refers to the difficulty of reprofiling debt when subnational governments encounter liquidity problems. The cost of rolling over debt increases dramatically. In some cases, debt cannot be rolled over at all. To the extent that rollover risk is limited to the risk that debt might have to be rolled over at higher interest rates, it may be considered a type of market risk. However, because the inability to roll over debt or exceptionally large increases in government funding costs can lead to, or exacerbate, a debt crisis—in addition to the purely financial effects of higher interest rates—such debt is often treated separately (IMF and World Bank 2001).

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


16. Although the economics literature approaches insolvency from the sustainability of fiscal policies, in a number of countries, specific legal definitions serve as procedural triggers for initiating insolvency procedures. In a legal sense, subnational
insolvency refers to the inability to pay debts as they fall due; however, details vary across countries. See Liu and Waibel (2008).

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

18. Such finance can take multiple forms, including direct borrowing as well as running arrears.

19. For how sovereign ratings affect subsovereign ratings, see Gaillard (2006). For how international rating agencies rate subnational creditworthiness, see Liu and Tan (2008).

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


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

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

24. Taxless finance schemes finance infrastructure investments in a way so that revenues are not raised immediately to finance the project. For examples of how states in the United States used taxless finance schemes in the 19th century and the state debt crises in the early 1840s, see Wallis (2004). For implications of the U.S. experiences for developing countries, see Liu and Wallis (2008).

25. For a summary of hidden and contingent liabilities in several developing countries, see Liu and Waibel (2006).

26. Bonds were a major source of financing in São Paulo in Brazil.

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

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

29. See Ter-Minassian and Craig (1997) for a summary of subnational borrowing control frameworks in more than 50 countries and Liu and Waibel (2006) for a review of ex ante regulations since the late 1990s in several countries. For comparative experiences of ex post insolvency mechanisms, see Liu and Waibel (2008).

30. The focus in this chapter is on demand-side regulation. On the supply side, various elements of the financial system, including competition and prudential regulations, come into play.

31. When South Africa restructured its legal framework for municipal finance and management system in the postapartheid period, a clear objective was to nurture a
competitive private municipal credit market in which private investors play a dominant role (South Africa National Treasury 2001: 192).

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

33. Insolvency law exercises a disciplining function (Paulus 2006).

34. The World Bank (2005) addresses creditor rights and insolvency standards in the context of corporate bankruptcy. Key principles apply to the subnational context, bearing in mind the differences between public and private bankruptcy.

35. The inability to compel holdouts to cooperate in a negotiated compromise motivated the passage of Chapter 9 of the U.S. Bankruptcy Code (McConnell and Picker 1993).

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

37. Statutory controls on subnational borrowing have always existed in Brazil—controls on new borrowing and on the total stock of debt, expressed as percentages of revenue. But they had loopholes, and subnational governments had been creative in evading them. The regulations were strengthened in the late 1990s, leading to the unifying framework in 2000.

38. For a review of Brazil debt crises and remedies, see Dillinger (2002). For a review of fiscal responsibility legislations in several Latin American countries, see Webb (2004).

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

40. Short-term borrowing for working capital is still allowed, but provisions should be built in to prevent governments from rollover borrowing as a way of long-term borrowing for operating deficits.

41. The fiscal responsibility legislation in Brazil tightly controls current expenditure and aims for positive primary balance. India’s 12th Finance Commission mandates that states eliminate revenue deficits (current expenditure exceeding total revenue), which implies that the borrowing is to finance capital expenditure only. The Colombian Fiscal Transparency and Responsibility Law (2003) specifies that the ratio of primary surplus over debt service be at least 100 percent. According to Peru’s Fiscal Decentralization Law (2004), article 24, and General Debt Law (2005), article 51, borrowing is solely to finance infrastructure projects. According to the Russian Budget Law (1998), in provisions relating to regional governments, current expenditure may not exceed total revenues and borrowing may be used only to finance investment expenditures. The South African constitution prohibits borrowing for consumption expenditure (South Africa National Treasury 2001: 192).

42. The debt service ratio measures the capacity to service debt. Many national governments monitor the debt service ratio of subnational entities, but they define payment capacity differently. Brazil, in its Fiscal Responsibility Law, defines it as a share of current revenue net of transfers. Colombia, in Law 358 of 1997, records it as a share of operational savings. India defines it as the ratio of debt service payments over total revenues. Peru, in a 2003 law amending its Fiscal Prudence and Transparency Law, treats it as a share of current income including transfers, while Russia, in its Budget Code, denotes it as a share of total budgetary expenditures.
43. See note 22 for the definition of revenue deficit.

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

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

46. South Africa has three spheres of government: federal, provincial, and municipal. Provinces generally do not borrow from the financial market.

47. See Dillinger (2002) for a review of state debt crises in Brazil and debt restructuring packages.

48. Bankruptcy Act of 1938 (“Chandler Act”), 50 Stat. 654 (1937), amending the 1898 U.S. Bankruptcy Act. The 1938 act was the first legislation for municipal bankruptcy in the world, even though other countries had contemplated the introduction of similar mechanisms—for example, Switzerland did so in the second half of the 19th century (Meili 1885). In 1934, the U.S. Supreme Court had declared a previous version of this legislation unconstitutional (see Ashton v. Cameron County Water Improvement District No. One, 298 U.S. 513).

49. The mandamus is a court order obliging public officials to take a certain course of action. For an excellent account on the mandamus and its motivation for Chapter 9, see McConnell and Picker (1993).

50. The enactment of the statute 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 the state legislature adopt new procedures for authorizing state borrowing. Other reforms at the time included opening access for infrastructure finance and development and eliminating taxless finance (Wallis 2004). For implications of the U.S. experience for developing countries, see Liu and Wallis (2008).

51. The three states with conditions are North Carolina, Pennsylvania, and most prominently, New York.

52. In Chapter 9 of the U.S. Bankruptcy Code, subnational insolvency is defined as the debtor either (a) currently not paying its debts as they become due, unless such debts
are the subject of a bona fide dispute, or (b) not being able to pay its debts as they become due. According to Hungary’s 1996 Law on Municipal Debt Adjustment, the two central triggers occur (a) if the debtor 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 or (b) if the debtor has not paid a recognized debt within 60 days of date due.

53. Only municipalities face a statutory requirement of insolvency. Section 109(c) imposes a procedural bar that is unique to Chapter 9 debtors: It requires prefiling efforts by the municipal debtor to work out its financial difficulties. The debtor must have reached agreement toward a plan or must have failed to do so despite good faith negotiations, or such negotiation must be “impracticable.” Also, according to section 109(c)(2), municipalities need state authorization to file for bankruptcy.

54. See the Law on Municipal Debt Adjustment (Law XXV, 1996). Four years after the law was enacted, neither vendors nor banks petitioned for bankruptcy. According to Jókay, Szepesi, and Szmetana (2004), these creditors probably assumed that the local governments had few liquid assets and that operational cutbacks could not produce a cash flow sufficient for fully satisfying claims.

55. In the United States, the Contracts Clause of the U.S. constitution (article I. section 10, clause 1) puts the principle of good faith in contracts into constitutional form.

56. Cram-down involves court confirmation of bankruptcy plans despite opposition of certain creditors. Under section 1129(b) of Chapter 11 of the U.S. Bankruptcy Code, courts may thus confirm a plan if it (a) was accepted by at least one impaired class, (b) does not discriminate unfairly, and (c) is fair and equitable.

57. For more detailed case histories, see Kupetz (1995) and McConnell and Picker (1993).

58. Chapter II, section 9(3), of the Law on Municipal Debt Adjustment stipulates the financial trustee’s independence.

59. Assets are distributed to creditors in the following order: (a) regular personnel benefits including severance pay; (b) securitized debt; (c) dues to the central government; (d) social insurance debts, taxes, and public contributions; (e) other claims; and (f) interest and fees on debt obligations incurred during the bankruptcy proceeding.

60. The U.S. experience suggests that in the absence of a bankruptcy framework, public entities in financial distress will use every possible technicality to challenge the validity of their outstanding obligations. Widespread challenges in a default wave during the 19th century led to the development of the bond counsel opinion, which certifies that the obligation is legal, valid, and enforceable.

61. For in-depth discussions and a review of the latest literature on intergovernmental fiscal systems, see Ahmad and Brosio (2006).

62. For how sovereign ratings affect subsovereign ratings, see Gaillard (2006).

References


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