Managing Subnational Credit and Default Risks

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State and local government debt and guarantees for quasi-public agencies debt have been growing in importance in developing countries. In Brazil subnational debt accounts for about 30 percent of total public sector net debt. The debt of Indian states represents about 27 percent of India’s GDP. Subnational debt financing has been historically important in the United States, with outstanding subnational debt at $2.36 trillion at the end of 2009.

The increasing share of subnational debt in consolidated public debt is not limited to federal countries. In China urban investment companies have been borrowing from financial institutions to finance large-scale infrastructure investments (Liu 2008). In France subnational governments account for more than 70 percent of public investment.

The increasing importance of subnational debt reflects, among other factors, the increasing decentralization of spending responsibilities, taxation power, and borrowing capacity to subnational governments. The unprecedented scale of urbanization in developing countries requires large-scale infrastructure investment financing to absorb massive influxes of people from rural areas. Subnational borrowing finances infrastructure more equitably across multigenerational users of infrastructure services, as the maturity of debt service paid for by the beneficiaries can match the economic life of the assets the debt is financing. In practice, however, subnational governments often also borrow for current expenditures.

With subnational borrowing come the risks of subnational insolvency. Systemic subnational insolvency may impede the growth of subnational...
capital markets, curtail fiscal space for infrastructure investments, and threaten financial stability and core public services, which may create pressures on the central government to provide financial assistance to ensure the continuing provision of essential public services. More autonomy for subnational governments increases the need for strong regulation for fiscal responsibility. During the 1990s subnational debt crises occurred in countries such as Argentina, Brazil, Mexico, and the Russian Federation, which have led to reforms to strengthen regulatory frameworks for subnational borrowing and insolvency.

The global financial crisis has had a profound impact on subnational finance across countries (Canuto and Liu 2010a). Subnational finances deteriorated across a broad range of countries at all income levels, although the degree of impact varied. Rating agencies viewed the impact of the economic downturn on the credit qualities of subnational governments as significant because of declines in the tax base, expenditure pressures or rigidities, and growing and more expensive debt (Fitch 2009; Moody’s 2010; Standard & Poor’s 2010).

The fragility of the global recovery and the growth of public debt have increased the importance of prudently managing subnational default risks. Beyond the current crisis, the structural trends of decentralization and urbanization are expected to continue with force, requiring prudent management of subnational default risks.

This chapter draws lessons from previous episodes of subnational financial distress and their interaction with sovereign defaults. It pays particular attention to the legal and institutional principles underpinning the debt-restructuring and fiscal adjustment process in subnational insolvency proceedings. Looking across countries, regulatory frameworks for subnational insolvency share central features, although the historical context and entry points for reform explain important variations. An important objective of the regulatory framework is to address soft budget constraints and the problem of overgrazing of the common resources by subnational governments. Fiscal rules for subnational governments or ex ante regulation attempt to limit the risk of subnational defaults; ex post regulation predictably allocates default risk while providing breathing space for orderly debt restructuring and fiscal adjustment, as well as the continued delivery of essential public services. However, ex ante and ex post regulatory systems alone cannot ensure the sustainability of subnational debt. The development of intergovernmental fiscal systems and financial markets, which falls outside the scope of this chapter, is equally important.

The chapter is structured as follows. The next section presents the motivation and rationale for regulating subnational debt financing. This motivation is country specific and shapes the design of the regulation. The second section summarizes regulatory frameworks, focusing on fiscal rules for subnational governments with respect to debt issuing, specifying the purpose, types, amount, and procedures of debt financing. The third
section explores key issues in designing insolvency mechanisms, encapsulated in the trade-off between protecting creditor’s contractual rights and maintaining minimum public services. The last section presents concluding remarks and draws policy lessons.

Rationale for Regulating Subnational Debt Financing

In response to the subnational fiscal stress and debt crises of the 1990s, countries such as Brazil, India, Mexico, and the Russian Federation have developed regulatory frameworks for subnational debt financing. Some newly decentralizing countries, such as Peru, developed frameworks for subnational debt while initiating decentralization, based on lessons learned from other countries on the fiscal risks associated with decentralization. Developed countries such as France and the United States have had their own experiences of subnational insolvency, which led to the establishment of systems to regulate the risks.

Subnational Debt Crises

Although expenditure-revenue imbalances may cause the development of subnational fiscal stress, the regulatory framework for debt financing profoundly affects the fiscal sustainability of subnational governments, because accumulation of fiscal deficits is feasible only when they have been financed. Such financing can take multiple forms, including direct borrowing and running arrears.

Unregulated subnational borrowing grew rapidly in countries such as Hungary and Russia in the 1990s, contributing to subnational fiscal stress. Borrowing by subnational governments 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, where at least 57 of 89 regional governments defaulted on debt payments between 1998 and 2001. 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 (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.5

The fiscal deficit itself may not be a problem if borrowing finances capital investment and economic growth. However, subnational governments
borrowed heavily to finance substantial operating deficits in countries such as Hungary, India, and Russia in the 1990s, leading to unsustainable debt paths. In India much of the growth in states’ fiscal deficits in the late 1990s was driven by borrowing to finance revenue deficits. At the height of the crisis, more than 70 percent of new borrowing was used to refinance existing debt in some states.

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

 Implicit or contingent liabilities have been a major source of fiscal deterioration in various developing countries. In the late 1990s, guarantees by Indian states to support market borrowing of loss-making public sector undertakings, a contingent liability, grew rapidly. Early episodes of subnational debt development in the 1840s in the United States show how contingent liabilities contributed to states’ debt crises (Wallis 2004). Important sources of implicit or contingent liabilities include off-budget entities wholly or largely owned by subnational governments, subnational civil servant pension liabilities under a pay-as-you-go system, nonperforming assets of financial institutions owned by subnational governments, and debt financing through arrears under the cash accounting system. (For a summary of hidden and contingent liabilities in several developing countries, see Liu and Waibel 2006.)

**Soft Budget Constraints**

Subnational debt-financing behavior is strongly influenced by the design of the intergovernmental fiscal system, the quality of the public financial management system, and the structure of financial markets. Market participants may tolerate the 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 (Ianchovichina, Liu, and Nagarajan 2007). A gap-filling grant transfer system, for example, induces subnational governments to run fiscal deficits by reducing incentives to raise revenue and increasing incentives to spend. Lack of own-source revenues for subnational governments in many countries undermines the ability of subnational governments to engage in fiscal correction, a core element of any debt-restructuring proceeding. Furthermore, a competitive capital market prices risks and returns of subnational lending, helping screen and discipline subnational borrowing. This market discipline could be undermined by the dominance of
lending to subnational governments by public banks. Abolishing central government’s explicit guarantees for subnational debt is not sufficient for nurturing the development of capital markets, as a range of factors, including implicit guarantees, affect demand and supply in the municipal finance market.

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 (see Weingast 2007 for a summary of the literature within the context of second-generation fiscal federalism). Unconditional bailouts of financially troubled subnational entities by the national government create moral hazard and the implication of a sovereign guarantee, which encourage fiscal irresponsibility and imprudent lending. In the United States, the no-bailout principle was established during the first subnational defaults in the 1840s (English 1996; Wallis 2004). In Hungary, one motivation for establishing a regulatory framework for subnational bankruptcy was to reduce moral hazard, impose a hard budget constraint on municipalities, shrink contingent liabilities of the central government, and change the perception among lenders that there was an implied sovereign guarantee (Jókay, Szepesi, and Szmetana 2004). After repeatedly bailing out subnational governments, Brazil adopted a stricter approach, demanding subnational fiscal adjustment in return for fiscal relief (box 11.1).

Box 11.1 Subnational Debt Crisis and Reforms in Brazil

Brazil substantially strengthened its ex ante regulations in response to repeated waves of subnational debt crises. Statutory controls on subnational borrowing have always existed in Brazil—controls on new borrowing and the total stock of debt, expressed as percentages of revenue—but subnational governments had been creative in evading them. The regulations were strengthened in the late 1990s, leading to the unifying framework in 2000. The federal government bailed out subnational debtors in earlier crises, but resolution of the third debt crisis in 1997 was conditioned on states undertaking difficult fiscal and structural reforms. Unconditional bailouts were avoided in 1997 in order 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 2000 Fiscal Responsibility Law consolidated various pieces of legislation into one unifying framework.

Sources: Dillinger 2002; Webb 2004.
Khemani (2002) tests the predictions implied by the common pool game in federations, where subnational governments are more likely to run higher deficits, because they do not internalize the macroeconomic effects of fiscal profligacy. She finds that in 15 major states in India over 1972–95, states have substantially higher spending and deficits (higher by about 10 percent of the sample average) when their government belonged to the same party as that governing at the center and that intergovernmental grants tend to have a (counterintuitive) negative effect on spending and deficits. These findings underscore the importance of political institutions in determining the consolidated government deficit relative to specific rules of intergovernmental transfers. A substantial reform undertaken by Indian states in the early to mid-2000s was the enactment of fiscal responsibility legislation.

Legal and regulatory frameworks for subnational debt financing serve as a commitment device to allow such 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 it to free ride, as it bears only part of the cost and reaps all of the benefits of unsustainable fiscal policies. Realizing these benefits depends on good fiscal behavior by most of the other subnational governments. Collectively, therefore, governments benefit from a system of rules that discourage defection and free riding. This commitment device controls and coordinates subnational governments in various localities and across time to commit future governments to a common borrowing framework (Webb 2004).

**Developing Regulatory Frameworks**

The motivations for developing regulatory frameworks differ significantly across countries, reflecting a country’s political, economic, legal, and historical context and triggering events. These differences affect the entry point for reform, the framework’s design, and its relation to subnational borrowing legislation. In particular, the frameworks for subnational debt financing and restructuring define the roles of different branches and tiers of government; a country’s political and economic history plays a key role in shaping the design.

Chapter 9 of the Bankruptcy Code of the United States (1937), for example, 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. Although the U.S. system offers a valuable reference, it cannot be copied without care. The Municipal Finance Management Act of South Africa (2003) was intended to address a number of challenges, including the development of a diversified and competitive subnational credit market (South Africa National Treasury 2001). The Hungarian Law on Municipal Debt Adjustment (1996)
sought to impose a hard budget constraint on subnational governments, establish a transparent rule-based debt-restructuring procedure without ad hoc political interventions, and rebut the presumption of any implied sovereign guarantee.

Subnational default risk can be managed through two channels: fiscal rules for subnational governments with respect to debt financing (that is, ex ante regulation of borrowing and monitoring of the subnational fiscal position) and ex post debt restructuring in the event that subnational governments become insolvent. Regulatory frameworks in many countries are still evolving, and the pace of putting together a full range of regulatory elements varies.

Ex ante fiscal rules and ex post insolvency mechanisms complement one another. Insolvency mechanisms increase the pain of circumventing ex ante fiscal rules for lenders and subnational borrowers, thereby enhancing the effectiveness of preventive rules. Without insolvency mechanisms, ex ante regulations could lead to excessive administrative control and game playing between the central and subnational governments. Overreliance on ex ante regulations could limit the role of markets in monitoring subnational borrowing and debt, however. In Canada and the United States, markets play a vital role in the surveillance of subnational borrowing. Although it takes time to develop market systems, developing countries can gradually foster the role of the market in the design of regulatory frameworks.

### Fiscal Rules for Subnational Debt Financing: Ex Ante Regulation

Fiscal rules for subnational debt financing deal with debt-issuing procedures. They specify the purpose, type, amount, procedures, and monitoring of debt financing. Regulatory frameworks for subnational debt financing have been strengthened in various countries (table 11.1).

Liu and Waibel (2008) identify several common elements in ex ante borrowing regulation across several countries. 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 requiring a balanced budget net of public investment (the “golden rule”). This rule recognizes that only such borrowing is beneficial (and may be in the interest of future generations). A number of middle-income countries, including Brazil, Colombia, India, Peru, Russia, and South Africa, have recently adopted the golden rule (see Liu and Waibel 2008 for details).

Second, the frameworks set limits on key fiscal variables, such as the fiscal deficit, the primary deficit, debt service ratios, and ceilings on guarantees issued. In India the 12th Finance Commission mandated fiscal responsibility legislation for all states, with the revenue deficit to be eliminated and the fiscal deficit reduced to 3 percent of gross state domestic
Table 11.1 Fiscal Rules for Subnational Debt Financing, by Selected Country

<table>
<thead>
<tr>
<th>Country</th>
<th>Rule</th>
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</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>Fiscal Responsibility Law (2000)</td>
</tr>
<tr>
<td>France</td>
<td>Various borrowing regulations and balanced budget rules</td>
</tr>
<tr>
<td>India</td>
<td>States Fiscal Responsibility and Budget Management Acts, following the recommendations of the 12th Finance Commission</td>
</tr>
<tr>
<td>Poland</td>
<td>Public Finance Law (2005)</td>
</tr>
<tr>
<td>Turkey</td>
<td>Various regulations since 2000</td>
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<tr>
<td>United States</td>
<td>States’ regulation</td>
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Sources: Liu and Waibel 2008; ongoing research by the authors.

product (GSDP) by fiscal 2009. Colombia established a traffic-light system to regulate subnational borrowing (Law 358 in 1997 and the Fiscal Transparency and Responsibility Law in 2003). Subnational governments rated in the red-light zone are prohibited from borrowing; those in the green-light zone are permitted to borrow. The red-light zone is reached when the interest to operational savings ratio is greater than 40 percent and the debt stock to current revenues ratio is greater than 80 percent. In Brazil the debt-restructuring agreements between the federal government and the states established a comprehensive list of fiscal targets, including the debt to revenue ratio, primary balance, personnel spending, and a list of state-owned enterprises or banks to be privatized or concessioned. In the United States, states set borrowing limits for themselves and, with a few exceptions, for their local governments.

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 facilitates debates by executive and legislative branches on spending priorities, funding sources, and required fiscal adjustments.
Fiscal transparency is increasingly becoming an integrated part of fiscal frameworks. Transparency includes having an independent audit of subnational financial accounts, making periodic public disclosures of key fiscal data, exposing hidden liabilities, and moving off-budget liabilities on budget. In Brazil, for example, Article 48 of the 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 government publish quarterly fiscal management reports that contain the major fiscal variables and indicate compliance with fiscal targets. Pursuant to Article 57, the report is to be certified by the audit courts.

Fiscal rules for subnational debt financing can be supported by regulations on lenders. To improve fiscal transparency, Mexico introduced a credit-rating system for subnational governments. Although subnational participation 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) 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 Laws 617 and 817. If it does not, the credit contract is invalid and borrowed funds must be restituted promptly without interest or any other charges.

Control and monitoring mechanisms can substantially reduce the risk of insolvency. Two contrasting examples are presented below: France, a unitary country, and the state of Ohio in the United States, a federal country, where local governments are political subdivisions of the states.

Notwithstanding considerable fiscal autonomy of subnational governments, the central state in France exercises strong supervision and monitoring of subnational governments’ financial accounts through three institutions: the prefect, the chambres régionales des comptes (regional chambers of accounts [CRC]), and public accountants. In the case of a budget deficit, late approval, or nonbudgeted mandatory expenses (such as debt service), the prefect (as well as any interested person) can refer the case to the CRC. If the subnational government does not follow the recommendations made by the CRC, the prefect can adopt the budget. The CRC also exercises financial supervision.

The key element of internal control in France is the separation of decision making (handled by the president of the local government council, who contracts expenditure) from actual payment (handled by the public accountant, who is part of the central government). This separation means that there are two sets of departmental accounts, which must tally. Public
accountants themselves are subject to audit and control by the central government.

The Fiscal Watch Program in Ohio, implemented by the Office of Auditor of State, acts as an early warning system to prevent local governments, including counties, municipalities, school districts, and state universities and colleges, from slipping into fiscal distress. A local government that is approaching a state of fiscal emergency, as defined by specific financial indicators, is placed under the fiscal watch program.

A local government under the program takes fiscal corrective actions. The fiscal watch remains in effect until the auditor determines that the conditions are no longer present and cancels the watch or until the auditor determines that the local government be placed under the fiscal emergency program under the predefined fiscal indicators. A commission will be formed for a local government under the fiscal emergency program, to assist in preparing and implementing a long-term financial recovery plan accepted by both the local government and the commission. The Auditor of State’s Office serves as financial supervisor to the commission and provides technical support and advice. It also examines the system of governmental accounting and reporting and identifies improvements that need to be made in a report.

The commission stops its activity under two conditions. The first is the elimination of the fiscal emergency conditions that prompted the initial declaration and the adoption by the local government of the necessary improvements in its accounting and reporting system. The second is the achievement by the local government of the objectives set forth by the financial recovery plan and the preparation of a five-year financial forecast that meets the evaluation criteria of the Auditor of State. If the fiscal emergency is terminated before these conditions are met, the Auditor of State is required to monitor the progress of the government to ensure full implementation of an effective accounting system and the elimination of the emergency conditions.

Regulatory Frameworks for Subnational Debt Financing: Insolvency Mechanisms

Ex post regulation deals with insolvent subnational governments. Notwithstanding fiscal rules for ex ante control, defaults can occur as a result of a subnational’s own fiscal mismanagement or as a result of macroeconomic or exogenous shocks. A well-designed insolvency mechanism serves multiple objectives: it enforces hard budget constraints on subnational governments, maintains essential services while restructuring debt, and restores the financial health of the subnational government so that it may reenter the financial market.
The need for a collective framework for resolving debt claims is driven by conflicts between creditors and the debtor and among creditors. Individual creditors may have different interests and security provisions for the debt owed to them; they may 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 (McConnell and Picker 1993). Individual ad hoc negotiations are costly, impracticable, and harmful to the interests of a majority of creditors. The holdout problem is less serious if debts are concentrated in a few banks. A collective framework for insolvency restructuring takes on more importance as subnational bond markets, with thousands of creditors, are more developed.

Clear creditor remedies allow collective enforcement and facilitate efficient debt adjustment. Creditors’ remedies in contract laws, rather than bankruptcy mechanisms, are effective at enforcing discrete unpaid obligations. However, individual lawsuits or negotiations become ineffective if there is a general inability to pay. This holdout problem causes uncertainty and prolongs the debt-restructuring process. Resolving the holdout problem was the primary motivation behind the United States’ enactment of Chapter 9 (McConnell and Picker 1993).

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. Each of these design considerations is examined below.

Public versus Private Bankruptcy

The public nature of the services provided by governments is the source of the fundamental difference between public insolvency and the bankruptcy of a private corporation. As a matter of public policy, public services essential for the public health, welfare, and safety must be maintained. This factor leads to the basic tension between protecting creditors’ rights and maintaining essential public services. Creditors have narrower remedies available for dealing with defaulting subnationals than they do for dealing with defaulting corporations, which leads to greater moral hazard (strategic defaults). 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 generally involves reorganization rather than the liquidation of assets. Additionally, subnational governments typically have some taxation power.

The debt discharge protects the subnational entity and its population from long-term harm caused by sharp reductions in public service delivery.
Thus, the insolvency system needs to balance incentives for the subnational entity to grow out of bankruptcy and the need to repay creditors. Crucial issues in designing such legislation are determining the balance between the legitimate contractual interests of private creditors and the delivery of essential public services, and providing subnational governments with the flexibility to grow out of their financial constraints.

The public nature of the debtor may justify limitations on creditors’ contractual remedies—a justification that does not apply to private debtors. Creditors will insist that all valid debts be honored and repaid. Ex ante the subnational entity may pledge assets for financial resources; ex post it will argue that many assets cannot be used for the satisfaction of creditors because they serve a public purpose. The tension between creditor rights and a subnational debtor’s inability to pay is here to stay. This tension is at its peak when a debt discharge is needed.

In principle, the answer of an insolvency framework to these competing interests is an equitable sharing of misery, a limitation on the subnational government’s ability to provide nonessential services, and a limitation on creditors’ remedies, including the discharge of debt. A subnational bankruptcy framework also provides guidance on the priority of settling competing creditor claims. Clear rules ease the distributional struggle between the need to maintain essential minimum services and the need to honor creditors’ contractual rights. This distribution also matters ex ante, as it shapes the expectations and behavior of the borrower and lenders in the next cycle of borrowing.

**Judicial versus Administrative Approaches**

There are two main approaches to subnational insolvency: judicial and 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, a priority structure for allocating credits among competing claims, and a determination of which services will be maintained. 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 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. Such interventions may also create a belief among lenders that the central government will intervene, thereby creating moral hazard.

The choice of approach varies across countries, depending on the history, political and economic structure, and motivation for establishing
an insolvency mechanism. In Hungary the 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 of the two approaches, blending administrative intervention with the role of courts in determining debt restructuring and discharge. After having bailed out insolvent subnational entities in the earlier debt crises, Brazil’s federal government chose an administrative approach in dealing with the third debt crisis, imposing 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, in 1937 the U.S. Congress adopted the municipal insolvency law known as Chapter 9 of the U.S. Bankruptcy Code. Chapter 9 is a debt-restructuring mechanism for political subdivisions and agencies of U.S. states. It provides the procedural machinery through which a debt-restructuring plan acceptable to a majority of creditors can become binding on a dissenting minority.

Many states have adopted their own frameworks for dealing with municipal financial distress, 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. Moreover, federal courts may not exercise jurisdiction over policy choices and budget priorities of the debtor. No uniform approach exists across states. New York City’s bankruptcy in 1975 and Ohio’s early warning fiscal monitoring system of the municipalities are two prominent examples of direct state intervention in resolving financial distress.

**Insolvency Procedures**

An effective insolvency procedure contains three main 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. Specific legal definitions serve as procedural triggers for initiating insolvency proceedings. Hungary (Law on Municipal Debt Adjustment 1996) and the United States (Chapter 9) define insolvency as inability to pay; South Africa uses one set of triggers for serious financial problems and another for persistent material breach of financial commitments (Municipal Financial Management Act 2003).

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. An initial determination must be made as to whether the situation reflects a genuine inability to pay or merely unwillingness to pay. The U.S. bankruptcy code erects obstacles to
municipal filing beyond those faced by private debtors, thereby discouraging strategic municipal bankruptcy filings.

Which parties may commence an insolvency proceeding differs across countries. In the United States, 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 Chapter 11, partly reflects the constraints imposed by the 10th Amendment to the U.S. Constitution, under which a creditor cannot bring a municipality into a federal court against its will. Like Chapter 9, Schwarcz’s (2002) model law for subnational insolvency allows only municipalities to file for bankruptcy. In South Africa any creditor can trigger the insolvency procedure (Chapter 13, Section 151(a), 2003 Municipal Financial Management Act). In Hungary a creditor can petition the court if a municipality is in arrears for more than 60 days (Law on Municipal Debt Adjustment [Law XXV 1996]).

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, fiscal adjustment is inherent to any insolvency procedures, requiring the difficult political choices of cutting expenditure, raising revenues, or both.

Ianchovichina, Liu, and Nagarajan (2007) present a framework for analyzing subnational fiscal adjustment. 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. Unable to issue their own currency, subnational governments cannot use seigniorage finance. They cannot freely adjust their primary balance because of the constraints on the taxation and expenditure system within the intergovernmental fiscal system.

Debt restructuring lies at the heart of any bankruptcy framework. 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 state bonds to repay maturing short-term obligations of the city, conditioned on the city making fiscal and financial management reforms (Bailey 1984). The 1997 debt agreements between the Brazilian federal government and 25 of its 26 states, which focused on ex ante regulations, may also be viewed as an ex post intervention, because the agreements were imposed on a case-by-case basis as a condition of debt restructuring.

Debt discharge is a major departure from the principle that contracts ought to be fulfilled. A mature judicial mechanism is well placed to
ensure that discharges are fair and equitable. In South Africa, for example, the municipality needs to go to the court for a discharge. Administrative procedures tend to lack the power to discharge debt.

The adjustment of debt obligations is a major intervention in contract rights. Insolvency law attempts to balance creditor rights, the inability of a subnational entity to pay, and the continued need of the subnational governments to provide essential public services. 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.20 A procedure for subnational insolvency recognizes that resolving financial distress through mechanisms guided by law is preferable to muddling through repeated, costly, and often unsuccessful negotiations.

One basic question with respect to debt restructuring is who holds the cramdown power when the sides fail to reach an agreement.21 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 (for case histories, see Kupetz 1995; McConnell and Picker 1993).

Unlike private entities, subnationals have no stockholders. Their officials need not pay off unsecured creditors to remain in control. Unsecured creditors are protected by §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 ensures that bondholders effectively receive what they would have received outside of bankruptcy.22

In Hungary the Debt Committee, which is independent of the local government, is charged with preparing a reorganization plan and debt settlement proposal.23 A debt settlement is reached if at least half of the creditors whose claims account for at least two-thirds of the total undisputed claims agree to the proposal. Creditors within the same group must be treated equally.24 The law also stipulates the priority of asset distribution. If disagreements arise on distribution, the court makes the final decision, which cannot be appealed.25

South Africa’s legislation stipulates that debt discharge and settlement of claims must be approved by the court. Under the Municipal Finance Management Act, claims are settled in the following order: secured creditors, provided that the security was given in good faith and at least six months before mandatory intervention by the provinces; preferences provided by the 1936 Bankruptcy Act; and nonpreferential claims.26

A clear priority structure for settling competing claims expedites the resolution of debt restructuring. Priorities also ease the pain of sharing the
reduced assets for distribution, because losses suffered by creditor groups may be predicted in advance. Hence, these priorities are more likely to be accepted. Moreover, the structure can keep the absolute size of losses in check, as the costs of protracted negotiations and litigation are high and often take priority over other claims. Priorities are a policy choice with a variety of trade-offs. If the lending community perceives that financial distress is resolved largely on its back, desirable future lending could suffer. The priorities backstop voluntary restructuring negotiations, because creditors know their position in the hierarchy of payment in the insolvency procedure. The shadow of priorities shapes the bargaining power of creditors and debtors even outside bankruptcy.

Distributing the pool of available assets in bankruptcy is not only about efficiency and equal treatment. Which policy is most appropriate will depend on the distributional preferences of the society concerned and 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.

Concluding Remarks

As a result of decentralization around the world, subnational debt accounts for an increasing share of countries’ public debt. Rapid urbanization and demand for large-scale urban infrastructure will continue to put pressure on the public finance system to finance sustainable investments. In many countries decentralization has devolved responsibility for most infrastructure investments to subnational governments. Managing subnational debt financing and its sustainability is critical to a sustainable public finance system and sovereign financial health.

As Canuto and Liu (2010a) note, the financial crisis has had a significant impact on the financial accounts of many subnational governments, as a result of slower economic growth, uncertainty over the cost of financing, and pressure on primary balances. Beyond the current crisis, the structural trends of decentralization and urbanization and the need to finance urban infrastructure are likely to continue.

Subnational governments in various major developing countries entered the current global financial crisis with stronger fiscal positions than they previously had, as a result of their reforms in the fiscal rules and regulatory frameworks. However, the uncertainty of the global public debt market, the potential risks of the rising cost of capital, the fragility of global recovery, and currency uncertainties and associated refinancing are continuing to put pressure on subnational finance (Canuto and Liu 2010b).

There are also risks of increasing contingent liabilities. Shifting borrowing off-budget may become a convenient way of circumventing fiscal rules. Subnational governments may turn to alternative forms of infrastructure
investing, including public-private partnerships, special purpose vehicles, and off-budget financing. Such financing, if not properly regulated, can increase government’s contingent liabilities.

A range of middle-income countries, and low-income countries in transition to market access, are also contemplating expanding subnational borrowing and debt financing. Before they do so, their first priority should be to establish clear fiscal rules that specify the type and purpose of borrowing, identify the procedural steps for contracting debt, indicate any limitations on borrowing, and control and account for off-budget liabilities.

Ex post insolvency mechanisms are also essential to the sustainability of subnational debt financing. Even if rarely invoked, they shape expectations about defaults and encourage stakeholders to resolve subnational financial distress efficiently. Notwithstanding the fiscal problems of a particular subnational government, an effective insolvency system helps maintain access of other subnational governments to the public finance markets. Clear and predictable rules on priority of repayment ease the struggle and allow faster resolution of financial distress. Effective insolvency and creditor rights systems allow better management of financial risks.28

The management of subnational default risks is intertwined with broader macroeconomic and institutional reforms. Macroeconomic stability and sovereign strength cap the financial ratings of subnational governments, thereby affecting the availability and cost of funds for subnational governments. 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. Managing default risks does not mean minimizing subnational governments’ access to debt financing. On the contrary, developing a competitive and diversified subnational credit market is critical to intermediating national savings and infrastructure financing. An effective management of subnational default risks thus goes in tandem with broader development of capital markets.

Notes

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1. The term subnational refers here to all tiers of government and public entities below the federal or central government, including states, counties, cities, towns, public utility companies, and other special-purpose public entities that have the capacity to incur debt. In Brazil net debt is the difference between gross debt and assets. Data are as of December 2009 (www.bcb.gov.br/?FISCOPOLICY).
2. Figures are as of December 2009 (www.rbi.org.in). Debt would be higher if debt on the balance sheets of companies such as power and water, which are wholly or largely owned by the states, were included.


4. In a legal sense, subnational insolvency refers to the inability to pay debts as they fall due. Definitions of insolvency vary across countries, however. In addition to default (failure to pay according to the terms of the debt instrument), insolvency is characterized by a genuine, and not merely a temporary, shortfall of resources to service debt (see Liu and Waibel 2009).

5. For a discussion of how sovereign ratings affect subsovereign ratings, see Gaillard (2009). For a discussion of how international rating agencies rate subnational creditworthiness, see Liu and Tan (2009).

6. This statement assumes 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. In this case borrowing can still provoke a fiscal crisis, even when the proceeds have been put to good use. The statement also assumes the general government debt is compatible with market financing capacity without crowding out private demands.

7. The revenue deficit is the amount of current expenditure (such as wages, pension outlays, subsidies, transfers, and operation and maintenance) net of total revenues.


9. Between 1998 and 2001, at least 57 of 89 regional governments in Russia defaulted (Alam, Titov, and Petersen 2004). In 2001, six years after the peso crisis, 60 percent of subnational governments in Mexico still struggled financially (Schwarcz 2002). One interesting difference between Mexico and Russia is that subnational governments were allowed to borrow overseas in Russia, whereas such borrowing was prohibited in Mexico. Subnational governments in Mexico were not insulated from foreign exchange risks, however, which were transmitted through inflation and interest rates.

10. The holdout problem occurs when individual creditors who have different interests and security provisions for the debt owed to them demand preferential treatment and threaten to derail debt restructurings voluntarily negotiated between a majority of creditors and the subnational debtor (see McConnell and Picker 1993).

11. 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.

12. A clear objective of South Africa’s restructuring of its legal framework for municipal finance and management systems in the postapartheid period was to nurture a competitive private municipal credit market in which private investors play a dominant role (South Africa National Treasury 2001).

13. 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.

14. The fiscal targets were relaxed in response to the 2008–09 global financial crisis (www.rbi.org.in).

15. See http://www.auditor.state.oh.us.

16. The boundary between ex ante regulation and ex post insolvency is not clear cut. Fiscal responsibility regulation, for example, may incorporate elements of ex post consequences. Webb (2004) includes transfer intercepts and lender control mechanisms as part of ex post consequences. The focus here is on insolvency proceedings.
17. The Bankruptcy Act of 1938 (Chandler Act), 50 Stat. 654 (1937), amending the 1898 U.S. Bankruptcy Act, was the first piece of legislation in the world governing municipal bankruptcy.

18. Some states give blanket consent to municipalities to file in federal court, some states attach important conditions, and some states grant permission on a case-by-case basis (see Laughlin 2005).

19. The Contracts Clause of the U.S. Constitution (Article I. 10.1) puts the principle of *pacta sunt servanda* (agreements must be kept) into constitutional form.

20. 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.

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

22. The best interest test ensures that unsecured creditors are treated as well inside bankruptcy as outside of it. Creditors may nevertheless receive less than 100 percent of their claims. Unsecured creditors of municipalities are protected from the moral hazard problem of opportunistic bankruptcy filings not by the cramdown limit but by the best interests of the creditors standard (see McConnell and Picker 1993).


25. Law on Municipal Debt Adjustment, Law XXV, 1996, Chapter IV, § 31, assets are distributed to creditors in the following order: regular personnel benefits, including severance pay; securitized debt; dues to the central government; social insurance debts, public contributions, and taxes; other claims; and interest and fees on debt obligations continued during the bankruptcy proceeding.


27. In Brazil, subnational governments’ net debt as a percent of GDP fell from 18 percent in 2003 to 14 percent in 2007. In India, the fiscal deficit of states declined from 4.0 percent of GDP, on average, in 2000–05 to 1.5 percent in 2007–08, and states achieved positive operating balances. In Colombia gross debt by subnational governments as a share of GDP declined from 3.6 percent in 2001 to 1.4 percent in 2008. Subnational governments in both China and Russia had positive fiscal balances in 2007.


References


