Managing Subnational Debt
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Outlines

- Rise of Subnational Debt Market in Developing Countries
- Subnational Fiscal Risks and Debt Crises
- Regulatory Framework for Managing Subnational Fiscal Risks
- Ex-Ante Regulation
- Ex-post Insolvency Mechanisms
- Conclusions
Rise of Subnational Debt Market in Developing Countries

- Factors Contributing to the Rise of Subnational Debt Market
  - Decentralization has given subnational governments spending responsibilities and taxation power, and capacity to incur debt
  - Globalization, capital mobility, financial sector liberalization
  - Large and growing infrastructure financing needs, and Intertemporal financing nature of Infrastructure
Rise of Subnational Debt Market in Developing Countries

- Five Features of Subnational Debt Market
  - Subnational bond market increasingly important due to flow of international capital to developing countries, and diversification of financial instruments
  - Private capital has emerged as important (e.g., Hungary, Mexico, Poland, South Africa, Romania and Russia), though public institutions still dominate subnational lending in some countries (e.g., Brazil, India)
  - Subnational bond market volatile: steady annual growth from US$5.7 billion in 1992 to US$22.2 billion in 1995; a general downward trend to US$3.5 billion in 2001; revival since 2001. Subnational debt crises in 1990s (e.g., Argentina, Brazil, Mexico, and Russia) contribute to the volatility
Rise of Subnational Debt Market in Developing Countries

- Five Features of Subnational Debt Market (cont.)
  - Markets small and development uneven
  - Subnational bond limited to top-tier subnational governments
  - US subnational bond market as a comparison
    - Subnational bond market in US is the largest domestic subnational debt market
    - Subnational bonds outstanding US$2.2559 trillion (January 1, 2006)
    - Close to 10% of US domestic bond market and 26% of US public sector bonds
    - Individual investors are the largest holders, followed by mutual funds, money market funds, closed-end funds, bank trust accounts, banks, insurance companies and corporations
Subnational Fiscal Stress and Debt Crises

- Subnational debt crisis occurs when a large number of subnational governments become insolvent.
- Crisis can be widespread and default systemic.
- Subnational debt crises: Brazil, Mexico, Russia, etc.
- Potential risks in newly decentralized countries: Mexico, Hungary, Russia, Colombia, etc.
- Subnational fiscal stress: India, South Africa, Hungary.
  - As measured by consolidated fiscal deficit, debt service/revenue, etc.
Subnational Fiscal Stress and Debt Crises

- Subnational insolvency is a reoccurring event in development
- US examples:
  - In 1842, eight US States and the Territory of Florida were in default on their debt and three other States were in perilous financial condition
  - Modern defaults include:
    - Fiscal crisis of New York City in 1975
    - Bankruptcy of Orange County in 1994
Subnational Fiscal Stress and Debt Crisis

Contributing Factors

- Unregulated borrowing grew rapidly (Russia, Mexico, Brazil, Hungary, etc)
- Subnationals borrowed heavily to finance substantial operating deficits (Russia, India, Hungary, Mexico, etc)
- Increased spending on subsidies (India, Russia, South Africa, etc)
- Imprudent lending based on implicit guarantees from the central government (Russia, Mexico, Hungary, etc)
- Unregulated foreign borrowing (Russia, Brazil, etc)
Subnational Fiscal Risks and Debt Crises
Contributing Factors

- Risky debt profile: short maturity, high debt service ratio, variable interest rate (Russia, Mexico, etc)
- Imprudent lending by state banks and failure to subject subnationals to the discipline of capital market (Brazil, Hungary, India, etc)
- Macroeconomic crisis exposed the vulnerability of fiscal position of subnationals (Brazil, Mexico, Russia, etc)
- Deteriorating fiscal positions were not monitored carefully in all these countries prior to the crisis
Subnational Fiscal Risks and Debt Crisis
Hidden/Contingent Liabilities

- Types of Hidden and Contingent Liabilities
  - Civil servants pension liabilities
  - Local government-owned banks and their non-performing assets
  - Guarantees issued to support the borrowing of loss-making public enterprises
  - Off-budget activities
  - Arrears not captured by cash-accounting system
  - Liabilities arise from PPP contracts
Regulatory Frameworks for Managing Subnational Fiscal Risks

- Regulatory frameworks for ex-ante control
- Regulatory framework for ex-post insolvency
- They are not exclusive, complement each other
- Ex-ante borrowing framework incomplete without an ex-post resolution system
Regulatory Frameworks for Managing Subnational Fiscal Risk
Ex-ante Control: Selected Country Examples

- **Brazil**: Fiscal Responsibility Law, 2000
- **India**: 12th Finance Commission recommendations
- **Mexico**: Subnational borrowing framework (2000)
- **South Africa**: Municipal Finance Management Act (2003)
Managing Subnational Borrowing Risks
Ex-ante Control: Selected Country Examples

- Limits on fiscal aggregates (consolidated fiscal concept, balanced budget rule, debt service ratio, guarantees, etc)
- Colombia example (Ley 358 “Traffic Light Law” (1997), and Ley 819 (2003) sought to limit subnational debt to payment capacity.
  - Red light (prohibited from borrowing): interest/operational savings greater than 40%; debt stock/current revenues greater than 80%
  - Green light (allow to borrow): interest/operational savings less than 40%; debt/current revenue less than 80%.
- India (12th Finance Commission)
  - Fiscal responsibility legislation mandatory
  - Eliminating current deficit by 2008/09
  - Reducing fiscal deficit to 3% of GSDP by the same year
  - Annual intermediate deficit reduction targets
Managing Subnational Borrowing Risks
Ex-ante Control: Selected Country Examples

- Borrowing only for long-term public capital investment
- Procedural requirements (medium-term fiscal framework, budgetary process, etc)
- Fiscal transparency (independent audit, periodic public disclosure of key fiscal data, making hidden liabilities explicit, making off-budget liabilities on budget, monitor all liabilities, etc)
- Sanctions for violation of regulations (transfer intercepts for borrowers, invalidate lending for lenders, etc)
- Caution: relying on central government control on individual loan approval can limit the role of market
Ex-Post Regulation: Insolvency Mechanisms

- Deal with subnationals in fiscal stress or insolvency
- Debt restructuring and fiscal adjustment to restore subnational fiscal sustainability to
  - Maintain essential public services
  - Improve creditworthiness to re-access capital market
- Protect creditor rights to
  - Nurture embryonic capital markets
  - Lower cost of borrowing
  - Extend lending maturity
- Enforce hard budget constraint
- Resolve tension between maintaining public services and protecting creditors rights
Ex-Post Regulation: Insolvency Mechanism

- Collective framework for resolving debt claims when liabilities exceed assets
  - Resolving conflict between creditors and debtor
  - Resolving conflict among creditors: famous holdout problem
  - Individual ad hoc negotiation costly, impracticable, and harmful to the interests of a majority of creditors
  - Pre-determined rules allocating default risks and anchoring expectations: both debtor and creditors should share the pain
  - Enhanced credibility for no bailout policy

- Judicial approach enables fair debt restructuring and discharge of debt, but administrative approach allows higher levels of government to incentivize subnational to undertake difficult fiscal reforms
Insolvency Mechanism: Selected Country Models

- **United States**: US Bankruptcy Code, Chapter 9
- **United States**: State intervention on municipal fiscal and debt adjustment. Examples:
  - New York City Bankruptcy Crisis 1975
  - Ohio State early warning system
- **Hungary**: Law on Municipal Debt Adjustment (1996)
- **South Africa**: Municipal Financial Management Act (2003), Chapter 13
- **Brazil**: Federal Government and states debt restructuring program (1997)
- **Albania, Bulgaria, Romania**: Recent policy initiatives
Insolvency Mechanisms: United States

- Federal municipal insolvency law adopted in 1937, after default wave during the Great Depression
- Primary aim: deal with the holdout problem
- Requirement of State consent, rooted in strong federalist tradition
- Rarely used part of the US Bankruptcy Code
- States‘ own procedures, for example,
  - NY: 1975 Emergency Financial Control Board
  - Ohio: Fiscal Watch Program
Insolvency Mechanism: South Africa

- Municipal Financial Management Act (2003), Chapter 13 on Municipal Financial Distress
- Twofold motivations:
  - Guarantee continued access to capital markets by municipalities after demise of apartheid
  - Avoid future subnational financial crises
- Intervention: discretionary in financial distress, mandatory in serious financial distresss
- Potential full loss of local government financial autonomy, council dissolution
Insolvency Mechanism: Hungary

- The 1990 Act on Local Government made local governments independent entities
- Unfettered freedom to manage their finances and started to borrow for commercial activities => risk of insolvency
- Macroeconomic deterioration in 1995 exposed the seriousness of subnational financial distress
- Several local governments successfully lobbied for one-time grants from the central government.
- Two motivations for developing insolvency mechanism:
  - Discipline lenders and encourage credit differentiation.
  - Concern over contingent liabilities from deteriorating financial performances of local governments
- Judicial filing with appointment of an independent Trustee
Elements of Subnational Insolvency Mechanisms

- Insolvency triggers
- Debt restructuring and discharge
- Fiscal Adjustment
Element 1: Insolvency Triggers

- “Financial distress” & “Insolvency”: Defined by specific insolvency mechanism
- Courts may dismiss petitions filed in bad faith
- Generic definition: Inability to pay debts as they fall due
- US
  - Debtor generally not paying due debts
  - Unable to pay debts as they become due
- Hungary
  - Invoice not disputed or paid within 60 days
  - Not paid a recognized debt within 60 days
- South Africa
  - A set of triggers for serious financial problems and another set of triggers for persistent material breach of financial commitments
Element 2: Debt Restructuring

- Contribution required by creditors, given feasible fiscal adjustment
- Adjustment plan reconciles contractual commitments with payment capacity, preference to voluntary restructurings
- Restructuring binding on non-consenting creditors major departure from principle that contracts ought to be fulfilled
- Courts better placed to ensure equitable discharge
  - South Africa and US: Only courts have power to discharge debt
  - Brazil: Refinancing did not involve any discharge
- Creditors could stop lending if debt discharge perceived as “unfair”
Debt Adjustment: Hungary

- Debt Committee is chaired by a count-appointed financial trustee and charged with preparing a reorganization plan and debt settlement proposal. Fiscal and debt restructuring proposals are decided by a majority vote of the Committee.
- 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.
- The Act stipulates the priority of asset distributions. If disagreements arise on distribution, the court makes the final decision which cannot be appealed.
Element 3: Fiscal Adjustment

- Address root causes of fiscal imbalances
- Indispensable element in any insolvency mechanism
- Short- to medium term fiscal measures to enhance long-term debt sustainability
- Medium-term fiscal adjustment plan essential (Examples: US NYC, Orange County)
- Administrative mechanism typically more intrusive
  - Chapter 9 (US): municipality retains control over fiscal management
  - State intervention (US): State has broad power over its municipalities
  - South Africa: loss of financial autonomy
Element 3: Fiscal Adjustment
How Subnationals Differ from National

- Subnationals cannot issue their own currency, hence cannot use seigniorage finance
- Foreign exchange risk may not directly affect sub-national finance
- Monetary policy is at the purview of the central government
- Legal constraints to the ability of sub-national governments in raising their own revenues, a key determinant of fiscal adjustment
- Transfers from the central government are an important source of sub-national revenues
- Central governments may affect subnational fiscal finance and growth (wage policy, FDI, PPP, etc)
- Markets may tolerate unsustainable subnational fiscal policy if the center implicitly guarantees the debt services of subnationals
Conclusions

- Decentralization, financial market reforms, and large infrastructure financing needs lead to greater spending responsibilities and borrowing capacity by subnational governments.
- Subnational borrowing increases fiscal space for infrastructure spending.
- However, without proper regulatory frameworks, subnational fiscal risks can adversely affect service delivery, financial market and macroeconomic stability.
Conclusions

- Regulatory frameworks for managing subnational fiscal risks are part of wider institutional and governance reforms
  - Subnational fiscal transparency is a pre-condition for accessing capital market, requiring public disclosure and independent audit of fiscal accounts, consolidating off-budget activities, and measuring contingent liabilities
  - Intergovernmental fiscal system reform to strengthen local revenue base, which is important for accessing capital market
  - More competitive financial markets price and allocate risks more efficiently
  - Securities law and anti-fraud enforcement lower cost, increase investors’ confidence, and deepen financial markets