Subnational Borrowing Framework

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Outlines

- Subnational Borrowing in Developing Countries
- Benefits of Subnational Borrowing
- Risks of Subnational Borrowing
- Regulatory Framework for Subnational Borrowing
  - Ex-ante Regulation
  - Insolvency Mechanisms
- Reform Options for China to Consider
Subnational Debt Market in Developing Countries

- 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
- Subnational bond limited to top-tier subnational governments
Subnational Capital Market in US
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
- US$400 billion issued per year on average
- Individual investors are the largest holders, followed by mutual funds, money market funds, closed-end funds, bank trust accounts, banks, insurance companies and corporations
Benefits of Subnational Borrowing
Financing Infrastructure

- Additional source to finance infrastructure to stimulate and sustain economic growth
  - US: 60% of subnational infrastructure financed by bonds, 25% by own tax, and 15% by transfers
- Infrastructure investment benefit future generation, so future generation should also bear financing cost
- Maturity of debt should match the economic life of the assets that the debt is financing. Amortization of the liabilities is matched by depreciation of the assets financed
- Matching asset life to maturity term is sound public policy because these facilities can be paid for by those who use them
Benefits of Subnational Borrowing
Promoting Good Governance

- Exposing subnationals to market discipline, reporting requirements, and fiscal transparency
- Creditworthiness assessment is a precondition for subnational to access capital market
- Several emerging economies (Brazil, India, Mexico, Russia, South Africa, etc) are making progress on public reporting of subnational finance. Mexico has instituted credit rating of subnational governments
- Increasing attention to hidden/contingent liabilities
  - Off-budget activities, civil servant pension, arrears, guarantees, local government-owned banks, financial transactions between local governments and their public enterprises
Risk of Subnational Borrowing
Fiscal Stress and Debt Crisis

- Subnational debt crisis occurs when a large number of subnational governments become insolvent
- Subnational debt crisis: Argentina, Brazil, India, Mexico, Russia, etc
- Crisis can be widespread and default systemic
- Potential risks in newly decentralized countries (e.g., Mexico, Hungary, Russia)
- Subnational fiscal stress: India, South Africa, Hungary
  - As measured by consolidated fiscal deficit, debt service/revenue, etc
United States in the 1830s

- Many states aggressively sought debt financing of their large infrastructure projects
- Several state governments owned public banks which participated in the finance of infrastructure projects
- Some infrastructure projects were developed by the public enterprises created and owned by the states, others were financed by states but owned and operated by private entities
- As the states did not have sufficient tax revenues to finance the projects, they resorted to off-budget liabilities by using taxless finance to wipe the liabilities off the budget books
- As a result taxpayers assumed contingent liabilities
- 1840s state debt crises led to regulatory reforms on states borrowing and on separating state interests from private corporations
Subnational Debt Crisis: Causes

- 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)
- Risky debt profile: short maturity, high debt service ratio, variable interest rate (Russia, Mexico, etc)
Subnational Debt Crises: Causes

- 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
- Hidden and contingent liabilities serious issue
Managing Subnational Borrowing 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)
- 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 Mechanism

- 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
- Ex-ante regulation ineffective without ex-post insolvency mechanism
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, Macedonia, Romania**: Recent policy initiatives
Reform Options for China to Consider

- Subnational fiscal transparency
  - Pre-condition for accessing capital market
  - Public disclosure and independent audit of fiscal accounts
  - Consolidate off-budget activities, and measure contingent liabilities
- Restructure implicit subnational debt
  - Debt restructuring conditioned on fiscal reforms
  - Consider moral hazard and incentives for borrowers and lenders
- Gradual experiment to regularize borrowing
  - Fiscally-strong local governments can be allowed to access the market
  - Conditioned on fiscal transparency and budgetary reforms.
Reform Options for China to Consider

- Expand revenue bonds in utilities willing to undertake corporate governance reform
- Other reforms important as well, such as
  - 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