OTAVIANO CANUTO AND LILI LIU, EDITORS

UNTIL DEBT DO US PART

SUBNATIONAL DEBT, INSOLVENCY, AND MARKETS

THE WORLD BANK

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Subnational Debt, Insolvency, and Markets

Editors

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Part 3 Developing Subnational Debt Markets

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Abbreviations

ARI	average regular income
ARO	anticipated revenue credit operations
BLGF	Bureau of Local Government Finance
BPA	Bonneville Power Administration
CGCT	General Code of Territorial Entities, Code Général des Collectivités Territoriales
DAF	Fiscal Support Agency, Dirección General de Apoyo Fiscal
DBSA	Development Bank of Southern Africa
DCED	Department of Community and Economic Development, Pennsylvania
DGCL	Direction Générale des Collectivités Locales, General Directorate of Subnational Entities
DGCP	General Directorate of Public Accounting, Direction Générale de la Comptabilité Publique
DOF	Department of Finance
€	euro
ESF	Emergency Social Fund
EU	European Union
FC	Finance Commission
FEIEF	Fund for the Stabilization of the Federal Revenue for the Federal Entities, Fondo de Estabilización de los Ingresos de las Entidades Federativas
FIFA	Fédération Internationale de Football Association
FINDETER	Subnational Development Financial Entity, Financiera de Desarrollo Territorial, SA

fisc	the combination of a government's fiscal activity, which includes revenues, expenditures, and debts
FONPET	National Pension Fund, Fondo Nacional de Pensiones en las Entidades Territoriales
FPE	State Participation Fund
FRL	Fiscal Responsibility Law, Brazil
FRL	fiscal responsibility legislation, India
FUNDEF	Financial Fund for Educational Services
GDP	gross domestic product
GFI	government financial institution
GJMC	Greater Johannesburg Metropolitan Council
GNP	gross national product
GSDP	gross state domestic product
GTS	General Transfer System, Sistema General de Participaciones
IBGE	Brazilian Institute of Geography and Statistics
ICMS	value-added tax on goods, intermunicipal transportation, and communications services
IFI	International Financial Institution
IGP-DI	General Price Index, Domestic Availability
IMF	International Monetary Fund
INFIS	Institutes for Territorial Promotion and Development, Institutos de Fomento y Desarrollo Territorial
IPI	value-added tax on industrialized products
IRA	internal revenue allotment
IRRF	income tax withheld at source
ISS	service tax
KWK	Kloha, Weissert, and Kleine
LGC	Local Government Commission, North Carolina
LGU	Local Government Unit
LGUGC	Local Government Unit Guarantee Corporation
LWUA	Local Water Utilities Administration
MAV	national railways
MDFO	Municipal Development Fund Office
MEC	Member of the Executive Council
MFMA	Municipal Finance Management Act
MFPC	Ministry of Finance and Public Credit, Ministerio de Hacienda y Crédito Público

MHCP	Ministry of Finance, Ministerio de Hacienda y Credito Público
MOF	Ministry of Finance
MSRB	Municipal Securities Rulemaking Board
MVM	power grid
NCR	net current revenue
NPD	National Planning Department, Departmento Nacional de Planeación
NSSF	National Small Savings Fund
OCIP	Orange County Investment Pool
OECD	Organisation for Economic Co-operation and Development
OTB	Off-Track Betting Corporation
OTP	former monopoly state-owned savings bank privatized in 1995, Hungary
PACER	Public Access to Court Electronic Records
PAF	Incentive Program for the States' Restructuring and Fiscal Adjustment
PAI	Federal Immediate Action Plan (1993)
PFI	private financial institution
PICA	Pennsylvania Intergovernmental Cooperation Authority
PPP	public-private partnership
PSBR	public sector borrowing requirements
PSUs	public sector undertakings
PUDs	public utility districts
RBI	Reserve Bank of India
RCA	Regional Chambers of Accounts
RCL	net current revenue
RDF	rainy day funds
RLR	real net revenue
S&P	Standard & Poor's
SEC	U.S. Securities and Exchange Commission
SELIC	Special Settlement and Custody System
SELIC rate	prime interest rate: average charged on daily operations backed by treasury bills and bonds, registered at SELIC
SEMs	public-private partnerships, sociétés d'économie mixte locales
SGP	Central Government Transfers
SNG	subnational government
SOC	Superintendency of Corporations

SOE	state-owned enterprise
STN	National Treasury Secretariat
TSS	Tax Sharing System
UDC	Urban Development Corporation
UDIC	Urban Development and Investment Corporation
URV	real value unit
USAID	United States Agency for International Development
VAT	value-added tax
WPPSS	Washington Public Power Supply System
WMA	ways and means advances
ZAC	Centers of Urban Development, Zone d'Aménagement Concerté

Note: All dollar amounts are U.S. dollars unless otherwise stated.

An Overview

Otaviano Canuto and Lili Liu

Subnational Debt and Insolvency

State and local debt and debt of quasi-public agencies have grown in importance. Three structural trends have contributed to the rising share of subnational finance, including subnational debt, as a share of general public debt (Canuto and Liu 2010a).

First, decentralization in many countries has given subnational governments (SNGs)[1] certain spending responsibilities, revenue-raising authority, and the capacity to incur debt. With sovereign access to financial markets, SNGs are seeking access to these markets as well.

Second, rapid urbanization in developing countries requires large-scale infrastructure financing to help absorb influxes of rural populations.[2] Borrowing enables SNGs to capture the benefits of major capital investments immediately, rather than waiting until sufficient savings from current income can be accumulated to finance them. Infrastructure investments benefit future generations, which should bear a portion of the cost. Subnational borrowing finances infrastructure more equitably across multigenerational users of infrastructure services because the debt service can match the economic life of the assets that the debt is financing. Infrastructure services thus can be paid for more equitably by the beneficiaries of the services.

Third, the subnational debt market in developing countries has been going through a notable transformation. Private capital has emerged to play an important role in subnational finance, and subnational bonds increasingly compete with traditional bank loans. Notwithstanding the temporary disruption of the subnational credit markets during the 2008–09 global financial crisis, the trend toward more diversified subnational credit markets is expected to continue. SNGs or their entities in various countries have already issued bond instruments (for example, in China, Colombia, India, Mexico, Poland, the Russian Federation, and South Africa). More countries are considering policy frameworks for facilitating subnational debt market development (for example, Indonesia), while others are allowing selected subnational entities to pilot-test transaction and capacity-building activities (for example, Peru).

With debt comes the risk of insolvency. When SNGs follow unsustainable fiscal policy, it can jeopardize the ability to service their debt, the services they manage, the safety of the financial system, their country's international creditworthiness, and overall macroeconomic stability. Too often, the central government gets dragged in to provide bailouts, which can disrupt its own fiscal sustainability and reward the populist fiscal tactics of the recipient SNGs.

Several major emerging markets experienced subnational debt crises in the 1990s. Newly decentralized countries face potential fiscal risks. To many observers, runaway provincial debt in the Provinces of Mendoza and Buenos Aires was a factor behind Argentina's sovereign debt default in 2001. Brazil experienced three subnational debt crises in the 1980s and 1990s. In India, many states experienced fiscal stress in the late 1990s to the early 2000s, with increases in fiscal deficits, debt, and contingent liabilities. The 1994–95 Tequila Crisis in Mexico exposed the vulnerability of subnational debt.

Subnational insolvency is a recurring event in history. In 1842, eight U.S. States and the Territory of Florida defaulted on their debt, and three other states were in perilous financial condition (Wallis 2005). During the Great Depression, 4,770 local governments defaulted on US$2.85 billion of debt (Maco 2001). As capital markets and their regulatory framework matured, the default rates of U.S.

local governments declined. Yet there are recent episodes, including the default of the Washington Public Power Supply System in 1983, and the bankruptcy of Orange County, California, in 1994 and of Jefferson County, Alabama, in 2011.

The 2008–09 global financial crisis has had a profound impact on subnational finance across countries, as a result of slowing economic growth, the rising cost of borrowing, and deteriorating primary balances. The impact has been mitigated in various countries by fiscal stimulus, monetary easing, and increasing fiscal transfers. However, looking forward, pressures on subnational finance are likely to continue—from the potentially higher cost of capital, the fragility of global recovery, refinancing risks, and sovereign risks (Canuto and Liu 2010b).

Aligning Fiscal Incentives

Subnational debt crises have led governments across countries to search for frameworks to restructure subnational debt and to undertake legal, regulatory, and institutional reforms that will sustain subnational debt finance in the long run. In a multilevel government system, the reforms need to resolve three challenges (Liu and Webb 2011). The first challenge applies to governments at any level, whereas the second and third are relevant mainly in countries with multilevel governments.

The first challenge is the short time horizon of public officials, who have shorter terms of office than citizens' life spans. Public officials face the risk of being forced out of office if results are painful in the short term. The mobility of citizens and businesses between local jurisdictions means that excess borrowing could drive residents away and leave those remaining with more debt per person than they had anticipated.

The second challenge is free riders. The interests of individual subnational governments may diverge from the common national interest when factors such as electoral pressures motivate subnational governments to follow unsustainable fiscal policy. An individual government would bear only part of the cost of its misbehavior, but would still receive all of perceived benefit accrued, only if (most of) the other governments continued to follow good fiscal behavior. So, there might be a prisoners' dilemma—a situation where the equilibrium of isolated individual choices leads to suboptimal outcomes for all.[3]

The third challenge is moral hazard. Subnational borrowers might have an incentive not to repay their creditors, and creditors might lend without risk differentiations, if they perceive that defaulting debtors could be bailed out by the central government.

In a country with multilevel governments, the national government exists for the purpose (among others) of protecting the common interest, and typically has special powers such as running the central bank and regulating the financial sector. The national government also provides transfers to the SNGs, giving it additional leverage over SNGs and their fiscal behavior. However, the constitution and rules (such as on revenue sharing) may constrain the national government's power over the SNGs. Political considerations, such as the national political cycle or subnational political cycles, may bias the decisions of the national government away from the optimal (Braun and Tommasi 2004). For instance, when a state government of the same political party as the national government faces a close election, the national government might be inclined to "condone" the state's fiscal misbehavior by offering a debt bailout or rescheduling guarantee. Also, under some configurations of political institutions, the national executive might "purchase" blocks of legislative votes by giving SNGs fiscal favors.

The incentives in the political system affect the need for effective subnational fiscal control institutions. To the extent that the constitution and party system lead to more centralized power, the country may have less need for special institutions to coordinate fiscal discipline across governments over time and among SNGs. Decentralization and market decontrol, however, increase the need for coordination of fiscal discipline.

The subnational debt crises or fiscal stress of the 1990s in several major developing countries led to reforms in subnational borrowing frameworks, including the development of ex-ante fiscal rules and debt limits. The search for insolvency resolution has also intensified, since ex-ante rules have been shown not to be sufficient on their own without ex-post mechanisms. Insolvency mechanisms should increase the pain of circumventing ex-ante regulation for creditors and debtors, thereby enforcing preventive rules.

Key Design Issues in Subnational Debt Restructuring

The country experiences in this volume reveal several design issues with respect to debt restructuring frameworks: (a) how to balance the tension between the contractual rights of creditors and the need for maintaining public services in the event of subnational insolvency; (b) how to define the respective roles of different levels and branches of government in resolving insolvency; (c) how to develop a collective framework for debt resolution; and (d) a basic choice among a judicial, administrative, or hybrid approach. The country cases show that country-specific circumstances—historical, constitutional, and economic context, and entry points for reform—influence the framework design in each country.

The framework design ultimately needs to address the challenges of fiscal incentives facing SNGs in a multilevel government system. A sound framework should reduce the moral hazard of subnational defaults, discourage free riders, bind all SNGs to pursue sustainable fiscal policies, and extend the short-term horizon of SNGs to minimize the impact of unsustainable fiscal policy on future generations.

Public and Private Insolvency

Insolvency of subnational governments differs from that of private corporate entities. The core difference is the public nature of the services provided by SNGs. Thus, debt restructuring inevitably involves a difficult balance between interests of the debtor (and the citizens it serves) and the creditors (and savers). While a corporation can be dissolved, this route is barred for SNGs. When a private corporation goes bankrupt, all of its assets are potentially subject to attachment. The ability of creditors to attach assets of SNGs is constrained in many countries. In the United States, a judicial doctrine typically holds that only proprietary property is attachable. "Proprietary property," subject to debt foreclosure, was defined by the U.S. Supreme Court as "held in (the municipality's) own right for profit or as a source of revenue not charged with any public trust or use"[4] (McConnell and Picker 1993).

Who Has the Authority over What?

Fiscal adjustment by debtors requires difficult political choices to bring spending in line with revenues and to bring borrowing in line with debt service capacity. In a decentralized system, tension exists between the role of the national government in enforcing collective fiscal discipline of SNGs and the fiscal autonomy of SNGs. Can a higher-tier government force spending cuts and tax increases in a lower-tier government? Can courts influence spending priorities and tax choices that are normally reserved for legislative and executive branches? How do a country's legal framework and political reality define the roles of different tiers and branches of the government? These are among the key issues that the case studies in this volume try to address.

Subnational fiscal adjustment is also complicated by the legislative mandates of the central government vis-à-vis subnational governments and the intergovernmental finance system (Ianchovichina, Liu, and Nagarajan 2007). Unable to issue their own currency, subnationals cannot use seigniorage finance. SNGs may not freely adjust their primary balance due to legal constraints on raising their own revenue, dependence on central government transfers, or the central government's influence on key expenditure items such as wages and pensions. Many other policies that affect economic growth and fiscal health of the subnational economy may also be determined largely by the central government.

Debt restructuring and debt discharge are complex processes but can be distilled into two basic questions: whether the creditors and the debtor can reach agreement on debt resolution; and who holds the cramdown power[5] when both sides fail to reach an agreement (Liu and Waibel 2009). In Brazil and Mexico, the national government led SNG debt restructuring, and there were no debt write-offs. In Hungary and the United States, the courts hold cramdown power when local governments and creditors negotiate.

Clarity of Rules and Collective Enforcement

Without an insolvency framework, subnational debtors and their creditors resort to ad-hoc restructuring negotiations. The need for a collective framework for resolving debt claims is driven not only by conflicts between creditors and the debtor, but also by competing interests among creditors and competing demands by constituents of the debtor. Individual creditors may have different security provisions for the debt owed to them and may demand preferential treatment and threaten to derail debt restructurings voluntarily negotiated between a majority of creditors and the subnational debtor—the "holdout problem." Individual ad-hoc negotiations can be costly and harmful to the interests of a majority of creditors (McConnell and Picker 1993). The holdout problem is not as serious if debts are concentrated in a few banks. A collective framework for restructuring takes on more importance as the subnational bond market develops and grows to include thousands of creditors.

Lack of clear rules for insolvency is likely to raise borrowing costs, and may limit market access for creditworthy borrowers. South African policy makers viewed clear rules for insolvency as critical to the growth of a broad-based competitive subnational capital market. In the United States, utilization of Chapter 9 of the Bankruptcy Code has carried a strong stigma for a defaulting municipality, to offset debtor moral hazard. Municipalities are thus wary that capital markets would interpret the filing for federal bankruptcy protection as a strong signal of financial mismanagement, to which lenders are likely to react by charging a risk premium.

The tension between maintaining essential services and creditors' contractual rights would imply that the pain of insolvency needs to be shared between creditors and the debtor. The insolvency mechanism needs to balance these competing interests and guide the priority structure of settling competing claims. The priority structure will depend, first, on the distributional judgment of the society concerned and, second, on the effect of a chosen priority structure on the capital market and its impact on new financing (Liu and Waibel 2009).

Judicial vs. Administrative Approach

The two approaches to subnational insolvency procedures discussed in this volume are the judicial and the administrative.[6] Various hybrids also exist. In judicial procedures, courts make decisions to guide the restructuring process. The judicial approach has the advantage of neutralizing political pressures during the complex restructuring. However, the courts' ability to influence fiscal adjustment of SNGs is limited because mandates for budgetary matters usually rest with the executive and legislature. In some administrative interventions, by contrast, a higher-level government intervenes in the entity concerned, temporarily taking direct political responsibility for many aspects of financial management and restructuring the subnational's debt obligations into longer-term debt instruments.

The choice of approach varies across countries. In Hungary, the desire to neutralize political pressure for bailing out insolvent subnationals favors 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. Colombia has a formal administrative process, where central government representatives facilitate restructuring negotiations between subnational borrowers and their creditors, and supervise the implementation of the agreement on fiscal adjustment and debt workouts. In Brazil, the federal government restructured the subnational debt in the late 1990s conditional on the SNG undertaking fiscal reform and adjustment packages. Similarly, the federal government in Mexico restructured states' debts after the Tequila Crisis, and a few years later introduced regulations on the lenders that effectively constrained the borrowers as well. In India, the federal government used a debt swap instrument as an incentive to encourage states to enact their own fiscal responsibility laws.

Reforms to Align Fiscal Incentives and Develop a Robust Framework

Reforms in subnational borrowing frameworks and debt restructuring mechanisms have gathered momentum in developing countries since the late 1990s. The objectives of reforms are broadly similar—strengthening fiscal management and preventing future insolvency. Often, these proceed in tandem with broader public finance reforms, macroeconomic stabilization, and the development of a robust medium-term fiscal framework and transparency. The reform paths and sequences that these countries chose reflect their own historical context, legal framework, and reform dynamics.

This volume surveys the reform experience of selected countries in strengthening subnational fiscal discipline and developing a framework for the resolution of subnational debt stress. The first two sections of the volume focus on two types of debt restructuring. One type is the national-government-led debt restructuring, which includes the experiences of Brazil, India, and Mexico. The review also includes China's experience in central-government-led restructuring of the rural education legacy debt, so that local governments could gain stronger fiscal capacity for education service delivery. Another type focuses on the framework that spells out, in advance, the procedure in place in the event of a subnational default. It compares the experiences of Colombia, France, Hungary, and the United States. Subnational insolvency is not limited to developing countries. The reform experience of developed countries offers important lessons.

The third section of the book discusses the experiences of China, the Philippines, Russia, and South Africa in developing their subnational credit markets. This topic is highly relevant to aligning fiscal incentives for SNGs and developing a robust regulatory framework. When the central government refrains from bailouts, creditors serve as an enforcer of fiscal discipline on SNGs by pricing risks of defaults. Reducing default risks is not the same as minimizing the use of debt instruments. As already noted, debt instruments are essential for financing large-scale infrastructure and supporting economic growth. Competitive supply of subnational credits lowers borrowing cost and extends loan maturity.

We also include the United States, which has the largest subnational capital market in the world, with outstanding SNG (states and local governments and their special purpose vehicles) debt of US$3.4 trillion and an annual average issuance of US$450 billion. However, the United States was not endowed with a mature, well-functioning market from the outset. Over its long history, the U.S. subnational capital markets experienced episodes of widespread defaults in the 1840s, 1870s, and 1930s. The reforms of legal frameworks and institutions have been gradual and path dependent, in the sense that later reforms built on earlier reforms. The United States experience offers lessons for developing countries, but a developing country could not simply duplicate the institutions that currently govern subnational borrowing in the United States. Nonetheless, the United States does offer relevant lessons including the importance of tying revenue sources to borrowing, transparency in markets for government credit, and creating interest among creditors in strengthening borrowing rules.

National-Government-Led Subnational Debt Restructuring

Part 1 of the volume reviews subnational debt restructuring in Brazil, China, India, and Mexico. Brazil, India, and Mexico all have a federal system, but the origins of their SNG debt crises differ, as do the formulations of their restructuring programs. The chapter on China focuses on the restructuring of rural school debt for better alignment of the intergovernmental fiscal system and supporting inclusive economic growth. These countries offer lessons on the common-pool and moral hazard problems inherent in debt restructuring and how they have moved toward rule-based transparent frameworks.

SNGs in **Brazil** experienced debt crises during the 1980s and 1990s, a period of macroeconomic instability, oil shocks, and a balance-of-payments crisis. Circumventing the strict controls imposed on SNGs, public sector borrowing increased substantially to finance capital investments. The federal government provided bridge loans to assist SNGs in rolling over their external debt, but SNG debt stress was unabated. The federal government restructured SNG external debt in 1989 and SNG debt owed to federal entities in 1993. With a substantial part of SNG debt unresolved and persistent pressures placed on the primary balance, the fiscal and debt position of SNGs continued to deteriorate. As hyperinflation was brought under control, the SNG debt obligations rose rapidly in real terms. The federal government initiated a third round of debt renegotiations in 1996.

During the first two rounds of debt restructuring, state politicians suffered minimal consequences and their creditors suffered almost none. The cycle of failure in discipline and cooperation came to a halt in the third round of debt restructuring, as the deeper political and economic incentives had changed after a national macroeconomic adjustment program ended hyperinflation and stabilized the economy. Beyond macroeconomic stabilization, the federal Real Plan sought to reorganize the entire public sector and privatize banks and public enterprises. The federal government offered SNGs incentives to restructure their debt, but also required them to undertake comprehensive structural and fiscal reforms, including privatization of state-owned banks and enterprises. Three of the four largest debtor states supported the reforms and formed the core of a critical mass of states ready to cooperate in fiscal restraint, making it worthwhile for additional states to join the reform.

The success of the Real Plan, together with the third round of SNG debt restructuring, created the political and economic conditions for enactment of the Fiscal Responsibility Law (FRL) in 2000. The law established limits and placed restrictions on key fiscal variables and assigned responsibility for enforcing the obligations and fiscal transparency requirements. Throughout the 2000s, state and municipal finances improved significantly. Total public net debt as a share of gross domestic product (GDP) declined from 52 percent in 2001 to 39 percent in 2010, with the decline at all three levels of government. The improvement in the SNG fiscal accounts is associated with Brazil's improved macroeconomic fundamentals, but has come at a cost in reduced SNG infrastructure investment.

Local governments in **China** resorted to borrowing to finance school facilities to meet the goal of universal nine-year compulsory education. In 2000, China achieved the goal, a historic accomplishment. However, the rural education debt became a significant fiscal burden on local governments. With the public policy goal in the late 1990s of inclusive economic growth, the debt financing of nine-year compulsory education in the rural areas was replaced by grant financing for all children. The new policy needed to address the legacy debt and its write-offs.

With a strong fiscal position, the central government could easily have written off the entire debt. This option was not chosen because it would have encouraged moral hazard. The debt restructuring program in 2007 shared the fiscal responsibility for debt write-off among three tiers of government. The central government grants used an output-based rather than an input-based formula, which took into account both the required expenditure to achieve basic provision of education and the local government fiscal capacity. This output-based approach was designed to prevent perverse incentives for local governments to increase the size of their debt or to reduce their service of debt in anticipation of more grants or bailouts. A local government that borrowed excessively would not gain extra advantage, and another local government that borrowed less or paid off its debt would not be in an unfavorable position.

The Constitution of **India** forbids states from borrowing abroad and requires them to obtain central government permission for domestic borrowing. The central government places limits on states' borrowing through the annual discussions with states on financing state development plans. While limiting explosive growth and systemic insolvency of state debt, the system did not prevent deterioration of fiscal conditions as indicated by high levels of debt over gross state domestic product in many states in the late 1990s. The outstanding state debt to GDP peaked at 32.8 percent during 2003–04, up from 20 percent during 1997–98, and interest payments as a share of revenue receipts increased from 16.9 percent to 26 percent over the same period. Factors contributing to the deteriorating fiscal accounts across Indian states in the late 1990s include the rapid increase in expenditures on salaries, retirement benefits, pensions, and subsidies; increased borrowing to support the growing revenue deficit (current expenditure in excess of revenue including fiscal transfers); and growth in contingent liabilities associated with fiscal support to state-owned public enterprises.

Since the early 2000s, fiscal reform has focused on moving toward a more flexible, market-linked borrowing regime within sustainable overall borrowing caps imposed by the central government and self-imposed state-level deficit caps. The federal government enacted the Fiscal Responsibility and Budget Management Act in 2003, which applies to the national government only, but some states had also adopted their own FRLs before the enactment of the federal FRL (for example, Karnataka and Punjab in 2002), and many states have since 2003 adopted FRLs in line with the national law. FRLs became mandatory after the Twelfth Finance Commission, and the federal government offered a sizable incentive to restructure high-cost debt to states for passing FRLs.

During the centralized system in **Mexico** before the 1990s, subnational debt was implicitly guaranteed by the federal government. Important controls and consequences were outside the formal rules and were based on political party connections. In the 1990s, Mexico's federal government inadvertently involved itself in the decision making for subnational borrowing through pledged transfers and the implicit guarantee of bailouts that came with them. Accordingly, creditors took little time to conduct thorough evaluations of subnational finances, and some local governments borrowed beyond their means. The main vulnerabilities of the subnational debt profile were the high ratio of debt over the shared revenues received by the states, and refinancing risks stemming from short debt maturity and floating interest rates. The 1994–95 Tequila Crisis resulted in a rapid currency depreciation, a sharp rise in interest rates, and sharp declines in the pool of shared revenues, all of which led to a state debt crisis. The development necessitated a costly federal bailout program that forced a rethinking of subnational lending parameters.

The federal bailout program rescheduled subnational debt into long-term inflation-indexed debt at affordable but positive real interest rates and granted four years of assistance payments. To avoid a recurrence of the fiscal crisis, each state had to agree to a fiscal adjustment program designed by the Secretariat of Finance, which monitored compliance prior to disbursement of the annual tranches of assistance, and brought most states to a good financial situation by the end of the 1990s. The indexed debt that the banks were forced to accept helped them avert total ruin and collapse of the system, but illiquidity of the assets and low return inflicted a penalty on the borrowers as well. The federal government also ended its policy of formally guaranteeing subnational debt, although as a transition it agreed to accept and execute contractual mandates by which the borrowers pledged their revenue-sharing transfers as collateral for the debt service. During 1999–2000, the federal government effectively required credit ratings for subnational governments and brought in a new subnational borrowing framework through tightened regulations on the lending side. The federal constitution left little scope for direct regulation of the subnational borrowers.

We have learned from the experience of Brazil, China, India, and Mexico that each debt restructuring regime needs to be based on the origin of the debt problem and the specific historical and institutional context of the debt stress. Debt restructuring plans must pay attention to their incentive effects. Rule-based debt restructuring reduces ad-hoc bargaining and adverse incentives; hard budget constraint prevents moral hazard; and burden sharing provides proper incentives and avoids free-riding behavior, while also recognizing the incentive role played by higher levels of government to leverage reform.

Subnational Insolvency Systems

Part 2 of the book discusses the development of subnational insolvency systems in Colombia, France, Hungary, and the United States. All four countries developed a framework for insolvency proceedings in response to subnational debt crises. But the frameworks differ across the countries, reflecting historical contexts, constitutional frameworks, entry points for reform, and institutional developments that are path dependent. While Hungary and the United States opted for court proceedings for insolvency, Colombia and France chose to use administrative proceedings. All four countries confronted key design issues, whether they were federal (the United States) or unitary (Colombia, France, and Hungary). Part 2 concludes with the 1983 default case of the Washington Public Power Supply System in the United States, the largest subnational bond default in modern U.S. history. This case illustrates the dynamic interactions among stakeholders that have ramifications for regulatory reform and market development.

In the late 1980s and 1990s, the trend toward political decentralization in **Colombia** was accompanied by more freedom for subnational borrowing. SNGs experienced debt stress in the late 1990s to early 2000s, exacerbated by the economic downturn. Contributing factors included weak bank lending supervision, excessive reliance on transfers, and permission to borrow for current expenditure, which blunted incentives for fiscal discipline. Although the SNG debt level was not high by international comparison, the arrears had been increasing by the late 1990s, and SNG capacity for debt service had weakened, due primarily to the decline in SNG own revenues and fiscal transfers.

The SNG debt stress led to substantial public finance reform. Colombia enacted several laws, mostly between 1998 and 2003, that regulate the origination of SNG debt and encourage fiscal responsibility. Law 550 (1999) deals explicitly with bankruptcy proceedings for SNGs. The essence of the proceedings is to evaluate and reconcile competing claims against subnational debtors, according to a defined priority structure. The procedures in Colombia are administered by the Superintendency of Corporations (SOC) in coordination with other central government institutions. Created in the 1930s, the SOC's unique role arose within a historical context in which the court system was weak.

The SOC administers bankruptcy procedures for both corporations and most government entities.

The implementation of Law 550 and other fiscal legislation has taken place in the context of improving macroeconomic performance of the country since 2003. There has been little divergence between the law and its practice. The protection offered by bankruptcy Law 550 enables insolvent SNGs to reach orderly debt restructuring agreements with creditors. Focusing on debt workouts, Law 550 has limited ability to address the root causes of fiscal stress and debt. Other complementary laws—mainly Laws 358, 617, and 819—work in several ways by limiting borrowing, promoting fiscal transparency, strengthening the budgetary process, and helping to finance debt restructuring.

During 1982–83 and 2003–04, two waves of decentralization in **France** devolved more powers to the three levels of SNGs: the municipalities, the departments, and the regions. This new institutional framework has enabled SNGs to enjoy a greater degree of autonomous expenditures, to raise their own taxes, and to borrow from financial markets, within ex-ante rules established by the central government. However, SNGs are subject to ex-post controls by the Prefect and the Regional Chambers of Accounts, and to ongoing controls by the Public Accountants.

The ex-ante fiscal rules and the regulatory framework for managing SNG fiscal risks were established after a period of unregulated borrowing by SNGs following the decentralization and subsequent debt stress experienced by some SNGs in the early 1990s. The regulatory framework combines the laws and regulations with three sets of institutions, while preserving considerable SNG fiscal autonomy. The laws and prudential rules regulate debt, liquidity, and contingent liabilities. The state exercises strong supervision and monitoring of SNG financial accounts through the Prefect, the Regional Chamber of Accounts, and Public Accountants. By law, SNGs cannot go bankrupt and public assets cannot be pledged as collateral. If an SNG is insolvent, the central government will intervene, enforcing fiscal adjustment and facilitating debt negotiations among the creditors and the borrower. SNG accounts may be placed under the control of the Prefect and the Regional Chamber of Accounts for several reasons, including failure to present a balanced budget, deficits exceeding 5 percent of operating revenues, and failure to make provisions in the budget for compulsory expenditures including debt services.

State supervision has helped to substantially reduce SNG insolvency risks, although several debt restructurings occurred in the last two decades. Nonetheless, the lack of a clear, established legal structure for priority payments creates uncertainties. Off-budget entities, such as public-private partnerships, pose contingent fiscal risks, a common challenge across countries.

The 1990 Law on Local Government in **Hungary** granted local governments unfettered freedom to manage their finances. They borrowed for commercial activities and long term to finance short-term operating deficits. The macroeconomic deterioration in the mid-1990s exposed the seriousness of subnational financial distress. Imprudent lending by public banks without proper evaluation of SNG creditworthiness was attributed to the assumed central government guarantee for subnational debt. Several local governments successfully lobbied for central government grants. This threatened to set a bailout precedent, raising concerns of adverse incentives for debtors and creditors.

Several options were debated at the time, including informal restructuring negotiations between creditors and local governments. The deteriorating financial performances of local governments caused a concern about creating contingent liabilities for the central government. The government eventually opted for a formal insolvency mechanism. Transparency and predictability were viewed as central to an effective subnational insolvency mechanism. The Law on Municipal Debt Adjustment, approved by the Hungarian Parliament in 1996, gives courts the central role in fiscal and debt adjustment for insolvent local governments.

The implementation experience has exceeded the expectations of the framers of the law. The legal procedure is transparent, moral hazard of bailouts has been minimized, and essential services have been maintained. The debt adjustment procedures have given participating municipalities a clean slate to move forward. However, many insolvency cases were resolved through informal negotiations. While bilateral negotiations are an integral part of all insolvency regimes, the nontransparency and potential asset stripping could negatively affect less-informed or smaller creditors and the public interest. Discussions are ongoing among stakeholders on making the pre-bankruptcy negotiated restructuring more transparent.

In **the United States**, after the initial refinancing of national and state debts incurred during the Revolutionary War, when the national government assumed the existing state debts, national government involvement in state and local government finances was minimal until the Great Depression and New Deal programs of the 1930s. It was not until 1933 that the national government began significant grant and transfer programs to the states (Wallis 1984). Since the 1930s, national, state, and local finances have been more closely intertwined, but the national government has generally maintained a no-bailout policy and has left the structure and regulation of subnational borrowing to state governments. As chapter 14 on U.S. state systems of local government borrowing shows, there are 50 different subnational finance systems in the United States.

In response to widespread municipal defaults during the Great Depression, the U.S. Congress in 1937 adopted a 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. The widespread subnational financial distress during the Great Depression revealed the practical drawbacks of the mandamus (a court order obliging municipalities to service debt obligations) and informal protracted negotiations between municipal debtors and creditors (McConnell and Picker 1993). Chapter 9 delineates the procedures whereby a debt restructuring plan acceptable to a majority of creditors can become binding on a dissenting minority.

The design of Chapter 9 was guided by the U.S. constitutional provisions that reserve the control over state and local government finances completely to the states. State consent is a precondition for municipalities to file for Chapter 9 in federal bankruptcy court. Chapter 9 is not the primary subnational insolvency mechanism in the United States. Only about half of states authorize their political subdivisions to file for Chapter 9 relief. The unique federal structure of the United States also profoundly influences the specific design of Chapter 9, where the federal courts have limited ability to impose conditions on the debt adjustment plan of an insolvent municipality. Most of the institutions that govern subnational government borrowing in the United States are embodied in state constitutions, state laws, and state administrative agencies.

The U.S. corporate insolvency laws have had influence on other countries. While the U.S. municipal insolvency framework offers a valuable reference for other countries, the framework itself cannot be copied without care. Chapter 9 was conceived with the narrow objective of resolving the holdout problem. It is based on a respected, independent, and competent judiciary that has the authority to reject a municipality's Plan of Adjustment. In many developing countries, intergovernmental systems are still evolving, lending to SNGs may still be dominated by a few public institutions, and judicial systems may lack capacity. The development of a subnational insolvency mechanism must be sequenced with other reforms.

To develop a legal framework to resolve financial distress, many countries face similar objectives and challenges, namely, the interest in the functioning of local government autonomy, safeguarding essential public services and the assets that provide such services, transparent procedures, the interests of creditors, and functioning subnational capital markets.

Part 2 of the volume also includes the largest municipal bond default in **the United States** since the 1950s. In 1983, the **Washington Public Power Supply System** (WPPSS) defaulted on US$2.25 billion in outstanding bonds. The debt issued by the WPPSS was ruled by the State Supreme Court as invalid and unenforceable. Therefore, filing for Chapter 9 was never an option. The default, a rare event in scale and frequency in the modern U.S. subnational debt market, offers a window into the interactive roles of market, the courts, the regulators, the debtor, the creditors, the federal and state governments, and taxpayers.

The WPPSS default shows that, even in a developed country, the issuance of debt for infrastructure has endemic risks such as the lack of transparency and disclosure, poor project management, and construction delays. But even if the debt issued is valid and legally enforceable, the mounting problems in construction delays, cost escalations, and difficulty in refinancing existing debt would have made it difficult for the WPPSS to pay back bondholders.

None of the bailout proposals was seriously considered by Congress. The government took minimal enforcement action against actors in the WPPSS drama, because the principle of self-regulation outweighed the cost of enforcing regulations. Although there was little government action, the amount of private damage litigation was unprecedented and resulted in many failed careers and business collapses. Very few individual market participants gained from the WPPSS disaster, but the market not only weathered the storm—it became stronger. The U.S. municipal market showed little evidence of damage resulting from the WPPSS default. Not only did the market quickly return to normal after the WPPSS default, but the period during which the WPPSS drama unfolded, from 1975 to 1985, was one in which total annual municipal bond issuance grew tenfold—a dramatic decade of growth in the history of the modern market.

Subnational Credit Market Development

Part 3 of the book focuses on subnational credit market development in China, the Philippines, Russia, South Africa, and the United States. Developing countries face long-term challenges in developing liquid, deep, and competitive subnational credit markets. In general, bank loans continue to dominate the supply of credit to SNGs in developing countries, and public financial institutions continue to dominate credit supply in some countries. Subnational securities markets in developing countries in general are small in scale and lack liquidity and secondary markets. The United States has the largest, most liquid, and most competitive subnational capital market, but the market development has interacted with a series of institutional reforms through its history. Although the lessons from the U.S. experience are highly specific to the history of the American states, there are some general lessons for developing countries.

China has been investing about 10 percent of its GDP annually in infrastructure, with SNGs taking on a large share of investments and rapidly transforming the urban infrastructure landscape. SNGs relied on central government onlending and their own off-budget vehicles—Urban Development and Investment Corporation (UDIC), borrowing directly from the financial markets mainly through loans but also bonds—and land assets-based finance to develop urban infrastructure. The limitations of these financing instruments became evident to policy makers in the mid-2000s. With central government onlending, SNGs have no market interaction with creditors, and the borrowing power and payment obligations are not linked. UDIC's off-budget debt is nontransparent. Financing infrastructure through land lease is not sustainable in the long run, because of the up-front collection of leasing fees.

China has undertaken reforms since 2009 to allow the issuance of provincial bonds and later the piloting of municipal bonds. Policy makers recognized that important preconditions for the issuance of bonds by provinces did not exist in 2009. It takes time to develop credit rating systems, and SNGs had no market access experience. The reform thus took a learning-by-doing approach. The central government acted as the issuing agency, with SNGs participating in the auctions. From 2009 to 2011, RMB 600 billion (US$90 Billion) of provincial bonds was authorized and issued. In 2011, reform took a further step: the State Council approved piloting of direct bond issuance by four cities (RMB 23 billion) without the central government acting as the issuing agency.

The reform helped SNGs finance the subnational matching part of investment projects in which the central government co-invested in response to the 2008–09 global financial crisis. The new debt instrument significantly lowered the financing costs for SNGs, enabled them to start acquiring market access skills, and linked the SNGs as debtors with their debt service obligations. Piloting municipal bonds without the central government as the issuer is one step further for SNGs to access the market.

The issuance of SNG bonds has been supported by developing legal, institutional, and market infrastructure. The reforms in fiscal management (including the single Treasury account and expenditure reforms) and separating management from ownership of public enterprises have laid the groundwork for the piloting of provincial bonds. The new bond instrument to finance capital outlays under newly developed budgeting procedures will facilitate the development of a framework for medium-term capital budgeting for infrastructure investments. The audit of, and the ongoing efforts to better classify, UDIC debt will facilitate the development of different bond instruments with different risks and securitization profiles. Further regulatory reforms can support sustainable market access, as would complementary reforms in strengthening intergovernmental fiscal systems, enhancing fiscal transparency, and deepening financial markets.

The Philippines is an emerging economy that continues to chart its own course in developing its subnational debt markets. The Philippines has been innovative in its efforts to extend the legal possibilities for local governments to take initiative in the use of credit and in the design of credit market techniques to make that possible. The Local Government Code, with its broad array of borrowing powers granted to local government units, and the creation of the Local Government Unit Guarantee Corporation to bolster local credits, are pioneering efforts.

The subnational debt market is small and levels of indebtedness are low. The risk of default is minimized by an intercept mechanism used to secure such debt. As a result, the lack of a formal insolvency system is not a key challenge for developing a competitive subnational credit market. There are more fundamental structural challenges, including institutional and political economy factors, which deter subnational governments from accessing private sector credit markets, and there is a lack of competition for subnational debt instruments.

The development of competitive subnational credit markets needs to address both demand- and supply-side constraints. On the demand side, it is critical to strengthen the local finance and accountability systems for citizens to demand better services. On the supply side, removing constraints to private bank participation in subnational credit markets will increase competition and help lower the cost of financing. Some financing instruments may help forge closer links between local governments' own revenues and their capacity to access the market, which in turn strengthens local accountability. The recent experiments encouraging greater partnerships between the local governments and the private sector credit markets could pave the way for a more competitive and diversified subnational credit market.

The subnational debt market in the **Russian Federation** began to develop in the early 1990s. Unfunded federal mandates and political decentralization contributed to the growing demand for debt instruments including foreign currency debt. At the same time, there was a complete lack of debt regulation, and SNGs lacked experience in managing debt risk. Debt was issued to finance recurrent expenditures, mostly with short-term maturities. With a rapidly deteriorating macroeconomic environment in Russia in the late 1990s, refinancing risks facing SNGs rapidly rose. Fifty-seven of 89 regions defaulted on their debt from 1998 to 2000.

Improved macroeconomic fundamentals during 2000–08 and substantial legislative reforms—significant amendments to the Tax Code, the adoption of the Budget Code, and the 2006 legislation on local self-government—contributed to positive changes in intergovernmental relations and incentives to formulate new principles of financial management for the regions and municipalities. The Budget Code contains provisions for regulating the subnational debt, including the provisional limits on deficit, debt and debt service, regulations of external borrowing, guarantees, and structure and types of debt instruments. With revenue growth, the financial positions of the regions and municipalities strengthened considerably. The debt load of the Russian regions remained low at the end of 2007.

The 2008–09 global financial crisis struck Russian public finances in 2009, though the impact varied across SNGs. There were, however, no regional defaults owing to support from the federal government and the liquidity accumulated by the regions in prior years. Since 2011, subnational fiscal positions have improved along with a gradual recovery of oil prices and the Russian economy. The debt markets have recovered and borrowing costs have declined. However, activity in the domestic bond market remained moderate until 2011, when the market expanded. There are continuing challenges in subnational debt market development. For example, most SNGs have short-term debt profiles dominated by one-year bank loans, implying higher refinancing risk; bank financing of the regions is dominated by a few state-controlled banks; and there is a lack of comprehensive accounting for the contingent liabilities of government enterprises.

In the post-apartheid era, **South African** municipalities faced the challenges of large-scale infrastructure investments to make up for huge backlogs left by the apartheid regime, rapid urbanization, and the need to accelerate economic development. The government's 1998 White Paper on Local Government stressed the importance of leveraging private sector finance to meet the infrastructure requirements of municipalities. This was followed by extensive stakeholder consultation between 1998 and 2003, leading to enactment of the landmark Municipal Finance and Management Act (MFMA). As part of the financial management, the act provides a comprehensive set of ex-ante rules regulating municipal borrowing. The act also spells out a procedural approach for dealing with municipalities in financial distress, which is important for lenders.

South Africa engaged in lengthy political consultations to develop insolvency procedures. Two constitutional amendments paved the way for a municipal insolvency mechanism. The South African case demonstrates the complexity of subnational borrowing and insolvency legislation and the path dependency of reforms. It illustrates the importance of building political consensus among various interest groups. Broad support may require concerted effort over a number of years. South Africa took two years to develop the basic policy framework (1998–2000), another year for cabinet approval (2001), followed by two years of parliamentary debate on the constitutional amendments and on the Municipal Finance Management Act (2001–03).

All metropolitan municipalities have, in the last decade, borrowed funds from the banking sector, capital markets, or both to finance infrastructure development. Since 2005, activity in municipal credit markets has risen quickly. Long-term borrowing increased rapidly in the run-up to the 2010 FIFA World Cup, changing the landscape of municipal finance from a high level of dependency on fiscal transfers to one where borrowing plays an increasingly important role in financing capital expenditure. Private lenders credit the MFMA as the most important factor in promoting market activities. There are continuing challenges, however, including the lack of a fully developed secondary market, the incompatibility of short-to-medium-term debt maturities with long-term assets of infrastructure, and the need to crowd-in more private financing in the market.

The United States has by far the largest local government capital market in the world, with the longest history of market development, achieved through a series of incremental changes in institutions over a long period of time. All the governments below the state level—what Americans call "local government"—are not sovereign, but rather are created by and subject to the laws of each respective state. Local governments borrow significant amounts of money to finance infrastructure investment and have very low rates of default. Local governments in most states face restrictions on how they borrow and what they can borrow for, and, in some states, how much they can borrow. For the most part, these restrictions are on the procedures that local governments must follow to approve borrowing and how debt service obligations are related to specific revenue sources (particularly in the case of revenue bonds).

A central feature of the American experience is the importance of ex-ante and passive insolvency systems. Twenty-three of 50 states prohibit their municipalities from filing Chapter 9 in federal courts. Only one-third of the states have a system in place for monitoring local governments, and less than 20 percent have institutions and policies that enable or require state action in the face of a local government fiscal crisis. The lack of active state programs does not mean that local government borrowing and debt servicing are not actively monitored by the larger society. Instead, it highlights how the interaction of ex-ante institutional rules, voters, capital markets, and courts play key roles in monitoring and limiting local government borrowing.

A distinctive feature of the American state systems is that they establish a close relationship between borrowing and taxation. Most of the states' constitutional reforms in the North that followed the states' debt crisis in the 1840s required states (and local governments after the 1870s) to raise current taxes when they issued debt (Wallis 2005). Forcing voters and taxpayers to simultaneously raise taxes when they borrowed money increased the burden on borrowing, and led voters to pay closer attention to the benefits of the expenditures and debt that local governments proposed. A similar set of incentives was set in motion with the development of special districts and revenue bonds at the end of the 19th century. The project that the bond proceeds will finance is securitized by the revenue streams of the project, and the beneficiaries (including future generations) of the project will pay user fees to finance the debt service.

The U.S. experience shows the importance of creating clear interest among creditors in strengthening both the rule of law and incentives for private market development. This is in marked contrast to a system where lenders assume that the central government would be, and often was, ultimately responsible for repaying debts. Passive insolvency systems also clearly require the existence of a strong and credible rule of law in order to work. Establishing the legal precedent that local taxpayers were not responsible for servicing debts that were incurred in an unauthorized manner or through defective procedures was a long, drawn-out process undertaken at the end of the 19th century.

The result of the framework for debt issuance has not been that local governments borrow wildly in unauthorized ways and then default, but rather a steady increase in the capacity of private capital markets to assess the creditworthiness of local governments and inform potential borrowers of the actual conditions under which local debt is issued and will be repaid. The institutional developments such as ex-ante debt rules (1840s), the bond counsel (the late 19th century), and the Municipal Securities Rulemaking Board (the mid-1970s) all make the provision of information to private market participants more credible and transparent. The national government has not violated the sovereign powers of states to tax, spend, and borrow as they wish, nor have they impaired the ability of states to establish systems for their local governments.

In principle, states possess the authority to unilaterally change the structure of any local government. In practice, however, states moved toward "general" laws governing local governments. This was an institutional change that arose endogenously in the American setting. If individual local governments could approach the state for special treatment, or if the state can single out individual local governments for special treatment (either positive or negative), then the incentives to create and enforce credible rules would be eroded. If all cities know that the same rules apply to all of them equally, then all cities collectively have a strong incentive to make sure that a state enforces the rules equally across all cities.

Lessons Learned

Structural trends of decentralization and urbanization are likely to continue in developing countries, requiring massive infrastructure investments at the subnational level. A range of middle-income countries, and low-income countries in transition to more open market access are contemplating expanding subnational borrowing and debt financing for infrastructure investments. The experiences of countries covered in this volume offer valuable lessons.

As shown by Canuto and Liu (2010a), subnational credit risks are intertwined with broader macroeconomic and institutional reforms. Macroeconomic stability and sovereign strength set an effective cap on the credit ratings of SNGs and influence the availability and cost of funds. Debt sustainability of SNGs is determined by the interplay of the existing debt stock, economic growth, cost of borrowing, and primary balance. Macroeconomic framework and policies strongly influence the interplay of all these factors. The history of subnational debt crises shows that unregulated borrowing, particularly in an unstable macroeconomic environment, is extremely risky; unfettered market access by subnational borrowers can outpace the development of sound revenue systems and adequate securitization.

Deficits and debt arise from the joint decision of governments making fiscal policy and their creditors. These decisions are made in light of not only the rules governing issuance of the debt, but also the expectations about what will happen to the debtor and the creditors if payment difficulties arise—who will lose money or who will be forced into painful adjustment. The decisions of that lending moment become a fait accompli conditioning the subsequent decisions. This points to two important dimensions of control of government borrowing. First, the type or timing—ex-ante controls or ex-post consequences; and second, whether the ex-ante controls and ex-post consequences act on borrowers or lenders.

Ex-ante constraints on subnational borrowers include procedural rules for incurring debt, limits on debt and deficit ceilings, rules for borrowing in international markets, and regulation of subnationals' borrowing based on fiscal capacity criteria. To complement the ex-ante constraints and to make them credible, there need to be ex-post consequences for failures in fiscal prudence. Without lenders there is no borrowing or debt, so their constraints and incentives deserve equal attention. Relying on constraints only on borrowers means that lenders still have incentives to push loans and may find reckless officials willing to borrow despite the rules.

Relying only on ex-ante constraints, without ex-post consequences, gives irresponsible borrowers and lenders an incentive to get around the ex-ante rules and execute transactions that will later get bailed out. Relying only on ex-post consequences allows irresponsible (and large) entities to build up such large debts that they could threaten macroeconomic stability.

Debt restructuring needs to pay close attention to its incentive effects. Rule-based debt restructuring reduces ad-hoc bargaining and adverse incentives; hard budget constraint prevents moral hazard; and burden sharing provides proper incentives and avoids free-riding behavior, while also recognizing that higher levels of government can create incentives for reform.

The purpose of borrowing and insolvency controls is not to minimize the use of debt financing, but rather to promote sustainable debt financing through a competitive and diversified subnational credit system. Such a system can help ensure the lowest cost of capital and a sustainable supply of credit. Debt financing is valuable for infrastructure development where the maturity of assets is generally longer than the current terms of taxation and transfers.

The dynamics of subnational-central government interaction provide reform momentum. On the one hand, one or a few subnational governments can serve as catalysts for fiscal reform and as a demonstration for national reform. On the other hand, the national government can offer fiscal incentives to encourage subnational fiscal adjustment. One common trait of successful debt restructuring for SNGs is the commitment of the central government to its own fiscal prudence.

The design for regulating debt and insolvency needs to be consistent with the broader cultural, economic, legal, constitutional, and social context of the country. Subnational fiscal adjustment and debt restructuring operate within a country's specific intergovernmental system that defines the respective authority of each level of government, and within a country's political system that defines the respective authority of each branch and level of government. Capacity and entry point for reform matter. The maturity of the legal system and the capacity of the judiciary influence the choices of procedure.

Regulations on debt and insolvency cannot compensate for inadequacies in the design of overall intergovernmental fiscal relations. The intergovernmental fiscal system underpins the fundamentals of the subnational fiscal structure. Without increased fiscal autonomy and greater own-source revenues, subnationals will rarely be in a position to borrow sustainably on their own. In addition, an intergovernmental fiscal transfer system that routinely fills deficit gaps will undermine the incentives for a balanced budget. The regulations on debt and insolvency cannot substitute for other reforms such as budgetary and financial management, taxation reform, and governance reforms. The incentive signals of insolvency mechanisms require a more competitive subnational capital market.

It is critical to understand the interaction of rules, enforcement, and capital markets. In the case of government borrowing, decisions to spend in the present must be matched with decisions to tax and service debt in the future. Well-functioning capital markets are a way for societies to pool the best information about conditions today and changes tomorrow. When governments possess the discretionary ability to change the rules between today and tomorrow, it becomes difficult for the capital markets to assess either the returns from financing infrastructure spending or the risks that debts will not be repaid.

The importance of closely tying borrowing decisions to revenue decisions as a feature of good institutional design cannot be overstated. Debts have to be repaid, and debt issuance that is tied to tax increases or dedicated revenue sources is much more likely to be repaid. The experiences discussed in this volume show the importance of moving to rules-based systems in which the higher-level government treats all lower-level governments according to the same rules. No matter what the rules, their ad-hoc or discretionary application is likely to be plagued with moral hazard and common-pool problems.

Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

1. The term *subnational* in this book refers to all tiers of government below the federal, or central, government. The category also includes special purpose vehicles or investment companies created by SNGs.
2. At the national level, estimations of future infrastructure investment requirements vary greatly by income level. Estache and Fay (2010) discuss methodologies for quantifying these requirements and estimate that low-income countries should spend 12.5 percent of GDP on investment and maintenance to meet demand, whereas lower-middle-income and upper-middle-income countries should spend 8.2 and 2.3 percent, respectively.
3. Inman (2003) develops the prisoners' dilemma model formally for this situation and shows how restrictive are the conditions under which the market successfully establishes subnational fiscal discipline if the central government takes a hands-off, no-bailout approach. The conditions include competitive

suppliers of local public services, a stable central government, clear and enforceable accounting standards, a well-managed aggregate economy, and an informed and sophisticated local government bond market.

4. This might include, for example, an unused vacant lot outside the corporate limits or a private residence taken for failure to pay taxes (McConnell and Picker 1993, 432).
5. To "cramdown" is the ability to force dissenting minority creditors to accept an agreement between a majority of creditors and the debtor.
6. In some places, there is no system, so "ad hoc" is a third system. In other places, defaults are dealt with as political problems, and there is no (or little) judicial or administrative capacity to deal with the problem.

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Part 1

Subnational Debt Restructuring

1

Brazil: The Subnational Debt Restructuring of the 1990s—Origins, Conditions, and Results

Alvaro Manoel, Sol Garson, and Monica Mora

Introduction

During the 1980s and 1990s, Brazilian subnational governments (SNGs) experienced extreme fiscal difficulties that resulted in increasing debt, giving rise to major renegotiations with the federal government near the end of the 1980s, in 1993, and during 1997–2000. In each period, the federal government undertook massive debt restructuring with states and municipalities. Each crisis had different underlying macroeconomic conditions and political economic dynamics, and the subsequent restructuring thus produced different results. The conditions and results are related to the evolving system of fiscal federalism in Brazil. The lessons drawn from these crises and the resulting debt restructuring are relevant not only for Brazil, as it continues to recover from the 2008–09 global financial crisis, but also for developing countries where fiscal decentralization is under way and debt continues to be an important instrument for financing economic growth.

The importance of Brazilian SNGs—that is, states and municipalities[1]—in the provision of goods and services gained ground in the 1980s and 1990s, as decentralization and urbanization deepened. In 1970, 56 percent of the total population of 93 million lived in urban areas. In 2000, 81.2 percent of the almost 170 million people did so, and the rate of urbanization reached 90.5 percent in the Southeast region, the most developed in the country. Throughout this period, SNGs accounted for nearly half of public sector spending and for most spending in education, health care, infrastructure, and public security.

The debt crises in the 1980s and 1990s evolved in the context of development and macroeconomic policies of the military government (1964–85). Public sector borrowing increased substantially to finance capital investments associated with rapid urbanization. These investments were undertaken mainly by newly created institutions such as public agencies and enterprises at both the federal and subnational levels. Federalism in Brazil revived in the 1980s with the return to democracy. The 1986 Congress, with strong representation of SNGs, crafted provisions for the 1988 Constitution that gave states significant authority and resources, including a much broader revenue base for the state-level value-added tax (VAT), but did not specify their spending responsibilities or set rules for fiscal prudence.

SNGs experienced debt stress during the 1980s, a period of macroeconomic instability that included oil shocks and a balance-of-payments crisis. Although the federal government provided bridge loans to assist SNGs in rolling over their external debt, the debt stress of SNGs continued unabated. The three subsequent debt restructurings (1989, 1993, and 1997–2000) dealt with different types of debt—external debt, debt owed to federal entities, and all other debt including market securities. The macroeconomic stabilization program in the early-to-mid-1990s, which was centered around the Real Plan, shaped the direction of the third debt restructuring. The Real Plan sought to reorganize the entire public sector, including the privatization of banks and public enterprises, and to reduce hyperinflation.

The most notable feature of the third round of debt restructuring was that it dealt with the underlying reasons for the subnational fiscal imbalance by focusing on the quality of fiscal adjustment and reforms. The federal government offered SNGs incentives to restructure their debt, but also required them to undertake comprehensive structural and fiscal reforms, including control over personnel spending and privatization of state banks and state-owned public enterprises. The success of the Real Plan, together with the third round of SNG debt restructuring, created the political and economic conditions for enactment of the Fiscal Responsibility Law (FRL) in 2000. The FRL established limits and placed restrictions on key fiscal variables and assigned responsibility for enforcing the obligations and fiscal transparency requirements.

Throughout the first decade of the 2000s, state and municipal finances improved significantly. SNGs began to generate a primary surplus of about 1 percent of gross domestic product (GDP), reversing the deterioration of the previous two decades. The limits imposed by the FRL on public spending, debt, and debt services were crucial to achieving these improved fiscal results and are central to the subnational debt restructuring agreements and the rules of budgetary and financial execution. Total public net debt as a share of GDP declined from 52 percent in 2001 to 39 percent in 2010, with the disaggregation declining in all three levels of government. The improvement in the SNG fiscal accounts is associated with Brazil's improved macroeconomic fundamentals.

This chapter reviews the Brazilian SNG debt restructuring implemented at the end of the 1980s and during the 1990s, and assesses its evolution within the macroeconomic context of crises, stabilization, and reforms. Section two provides a historical context for the origins of the SNG debt crisis. Section three defines the macroeconomic framework that gave rise to the high indebtedness of SNGs and details the successive rounds of debt renegotiation. Section four analyzes the evolution of SNG fiscal performance in the post-renegotiation era. Section five gives special attention to the 2007–10 period, and assesses the impacts of the 2008–09 global economic crisis on subnational debt and finance and the main fiscal federalism challenges emerging in the recent period. Section six draws some conclusions.

Fiscal Federalism, Centralization, and Decentralization: Historical Context

Fiscal federalism in Brazil has developed in alternating waves of centralization and decentralization of power. In 1891, the first constitution of the republic adopted a federal structure that decentralized revenues and gave states control of export taxes (Varsano 1996). It also gave governors, supported by regional oligarchies, control of the electoral process. The period 1930–45 was marked by a nondemocratic regime that favored fiscal centralization. The Constitution of 1946 marked the return to democracy and a more decentralized fiscal structure. This was followed by a military dictatorship from 1964 to 1985—a period of centralization and authoritarianism—and redemocratization after 1985, with SNGs increasing their share of revenues, but also accumulating mounting debt.[2]

Economic and Political Crises in the 1960s and 1970s and Authoritarian Rule

In 1964, a military government took power in the midst of a deep economic and political crisis and adopted a strategy based on two essential elements. The first comprised measures to stabilize the economy and promote fiscal and financial reforms. These reforms created a new tax system, which raised the overall tax burden and improved tax collection, and adopted modern financial instruments, creating (a) special funds made up of earmarked revenues, (b) the Central Bank of Brazil and the National Monetary Council, and (c) a mechanism for indexing financial assets to inflation.

The second strategic element reshaped the public administration by granting autonomy to the so-called indirect administration—agencies, foundations, public enterprises, and mixed public-private companies. A large part of the production of goods and services was transferred to them. Centralized planning and allocation of resources covered key sectors relating to national integration (for example, transportation and telecommunications) and basic materials (for example, petrochemicals, paper, and cellulose).

After the initial period of economic stabilization in the mid-1960s, Brazil entered a phase of accelerated growth of around 11 percent a year between 1968 and 1973, lower inflation, higher exports, and less volatile exchange and interest rates. The accelerated growth, however, highlighted the strong dependence of the country on capital goods and imported inputs, particularly petroleum and its derivatives. The growth of foreign debt and direct foreign investments increased debt servicing and the repatriation of profits abroad. To finance large-scale projects, the federal government also established special funds such as the Federal Fund for Urban Development and special public agencies such as the National Housing Bank. The use of foreign capital to finance not only investment but also working capital initiated a cycle of increasing indebtedness, which eventually culminated in a national debt crisis in 1982.

A political crisis arose in 1974, when the government-backed National Renewal Alliance Party suffered significant defeats in state and national elections. On the economic side, oil prices skyrocketed: the first oil shock increased oil prices by more than 300 percent from 1973 to 1974. The pressure on the balance of payments was magnified by a drop in exports that resulted from a sharp fall in global economic growth and rising interest rates. In mid-1979, the second oil shock led to rising interest rates, followed by higher costs of borrowing in the London market. Brazil, which had obtained foreign resources at floating interest rates, experienced a sharp drop in the supply of foreign credit and rising costs to roll over debt.

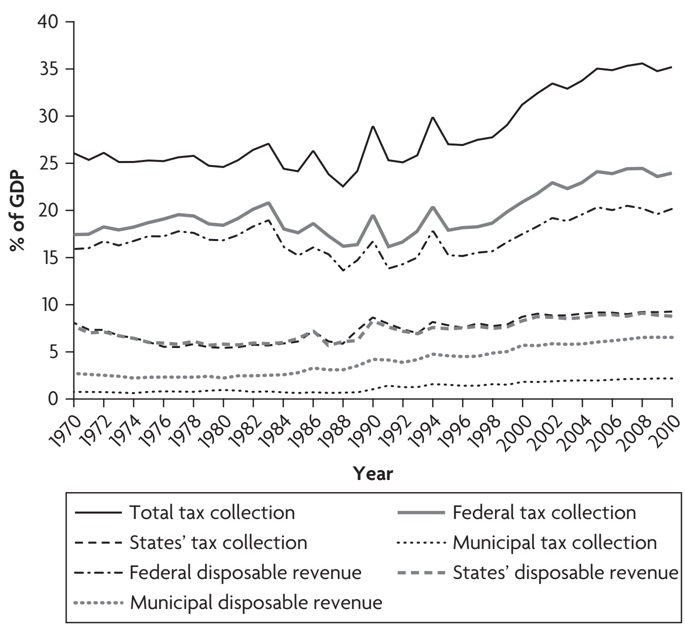
A huge balance-of-payments crisis was followed by tight domestic fiscal and monetary policies with significant impacts: (a) the federal tax burden increased from 18.4 percent of GDP in 1980 to 20.6 percent in 1983; (b) strict control of public spending negatively affected public investments; (c) GDP fell 6 percent during 1981–84; and (d) inflation accelerated from about 100 percent in 1982 to more than 200 percent annually during 1983–85, which resulted in an erosion of public revenues and a significant increase in the stock and service of public debt, which was indexed to inflation (see Hermann 2005).

Redemocratization in the Early 1980s: Rise in SNG Share of Revenue and Debt Distress

The elections of 1982 marked the first step in the redemocratization of Brazil. The return to direct elections at the state level in 1982, after 22 years of governors being appointed indirectly, allowed the new governors to recoup their sources of power, creating alliances with local governments due to the coincidence of state and municipal elections. The results strongly favored the opposition—10 of 22 opposition governors were elected—including in the largest and most powerful states. While the central government lost political influence, the governors benefited from the economic recovery in 1984 and 1985.[3] As a result, they were able to fulfill their mandates with high levels of investment (see Villela and Rezende 1986, 215). A 1983 constitutional amendment increased the transfers to SNGs and raised the tax basis of states. The states, which received 21.3 percent of disposable fiscal revenues in 1983 (corresponding to 5.7 percent of GDP), received 27 percent of revenues in 1986 (7.1 percent of GDP). At the same time, the municipalities increased their participation from 8.9 to 12.1 percent of available revenues, jumping from 2.4 to 3.3 percent of GDP, as shown in figure 1.1.

The wave of democratization in the context of the macroeconomic crisis of the late 1970s to early 1980s encouraged the population to turn to the SNGs for services, even those that were the responsibility of the federal government. During discussions in the National Constituent Assembly during 1987–88, governors and mayors fought for a larger share of public revenues. The 1988 Constitution greatly expanded the

Figure 1.1 National, State, and Municipal Tax Collection and Disposable Revenue in Brazil, 1970–2010



Sources: Afonso 2011; National Bank of Economic and Social Development; Secretariat of Fiscal Affairs.
Note: GDP = gross domestic product.

social responsibilities of the government; most of the expanded services provision was left to states and municipalities, however, which increased their expenditure obligations and, as a consequence, the borrowing requirements. As a result, in 1991, SNG participation in disposable fiscal revenue rose as high as 29.8 percent for states (7.5 percent of GDP) and 15.9 percent for municipalities (4 percent of GDP). Later developments, mainly higher tax rates in the form of higher social contributions (which are not shared with SNGs), allowed the central government to increase its share of disposable revenue.

Despite the increase in revenues, the SNGs' fiscal difficulties deepened, as demand for services rose and debt accumulated. The credit crunch, the difficulty of rolling over debt, and the strong indexation of debt to inflation deepened the fiscal vulnerability of the SNGs, which resorted to short-term credit called anticipated revenue credit operations (ARO), which by law is expected to be repaid in the same fiscal year, based on estimated tax revenue for the period. Nevertheless, this type of credit operation was often rolled over and accumulated year after year at much higher interest rates than regular credit or loans. In 1989, credit based on ARO accounted for 97 percent of state and municipal debt (see Lopreato 2000, 127).

In this difficult environment, the fiscal stance of the states and municipalities deteriorated significantly. In addition to their weak planning and fiscal management capacity, states and municipalities could not count on adequate sources of financing for their increased spending. Thus, several SNGs, in particular the states, ended the decade in massive fiscal distress.

The subnational debt crisis, which erupted in the 1980s and the 1990s, was largely the result of the institutional reforms of the military government, which allowed debt to become a key source of funding for governments. The regulations, which facilitated the access of public (and private) sectors to external resources in an environment of strong international liquidity, led to an "economy of debt." While the term "economy of debt" explains a good part of the subnational debt story during this period, the responsibility of some states and municipalities must also be understood. The most notorious example is that of the Municipality of São Paulo, whose debt was greater than that of the majority of states.

Until the mid-1960s, the ability to raise funds was hampered by a legal ceiling on the nominal interest rate, which discouraged lenders in an environment of high inflation rates. Military government reforms included adjusting the value of bond debt for inflation (Almeida 1996). Removing the legislative cap on nominal interest rates was one of the most important reforms initiated by the military regime, because it helped develop a modern capital market in the country.

Borrowing became a mechanism to circumvent the strict controls imposed on states and municipalities. The 1967 Constitution empowered the Senate to authorize SNG domestic and external credit operations. The rules for contracting operations were defined by the central bank, which was responsible for regulating the financial and banking systems. In 1975, Senate Resolution No. 93 set strict rules for contracting credit operations. However, foreign operations and the so-called "extra limit" were not regulated. To induce the states and municipalities to act in line with the federal government's interests, the social and urban projects considered as priorities by the federal government were funded by those "extra limit" operations. Having passed through the arbitrary sieve of the federal government, and authorized by the Senate, those operations became significant. After the second oil shock in 1979, regardless of the payment capacity of SNGs, the state and municipal public companies were induced to borrow from abroad as part of the federal strategy to reverse the public sector's balance-of-payments deficit.

To deal with the debt crisis unleashed by the Mexican moratorium in 1982 and the consequent need to turn to the International Monetary Fund (IMF) as the balance of payments deteriorated and foreign reserves dwindled, the federal government adopted a tight fiscal policy in 1983–84. The tax burden was increased to 27 percent of GDP, and public investments were severely reduced. Nevertheless, inflation continued to erode tax revenue and swell public debt. SNG budgetary and financial management was strictly conditioned by macroeconomic policies defined at the federal level. During the 1980s, SNGs were awarded "bridge loans" through the National Treasury so that they could roll over their external debt. In this way, SNG external debt was transformed into "domestic" debt, with the federal government as the main creditor.

SNG Debt Renegotiation and Its Macroeconomic Context

Brazil experienced three major subnational debt renegotiations from the late 1980s to the late 1990s. These renegotiations must be understood within the broader context of macroeconomic and political reform. The focus of each renegotiation grew progressively broader. The first round focused narrowly on changing the terms of debt repayment. The second round accompanied major efforts to stabilize the macroeconomic situation and make the government more efficient, as the Brazilian economy moved from state control to open markets. The third round consolidated the fiscal adjustment with enactment of the FRL in 2000. This section briefly describes the main rounds of renegotiation and analyzes their links with macroeconomic stabilization and fiscal consolidation.[4]

Addressing SNG Debt Distress: Three Major Renegotiations

The first round of SNG debt renegotiation in 1989 focused on resolving SNG external debt. This problem had been fueled by the federal government itself, which had sought to raise funds to fill the balance-of-payments gap. Based on Law No. 7976 of December 27, 1989, the federal government refinanced SNG debt, which included federal government loans in order to honor foreign debt guaranteed by the National Treasury or contracted until the end of 1988.

In 1991, following the inauguration of new governors and the failure of the President Collor Plan II,[5] authorities from all levels of government began to discuss a new approach, which led to the adoption of Law No. 8388 of December 30, 1991. However, the institutional crisis resulting from the impeachment of President Collor in 1992 postponed implementation of the law until 1993, when the second round of debt renegotiation started.

The second round of SNG debt renegotiation in 1993 concentrated on the debt owed to agencies and entities controlled by the federal government. Law No. 8727 of November 5, 1993, included outstanding amounts of loans contracted during the military period of 1964–85 for investments coordinated by the federal government.[6] The new law restructured the terms of payment by extending the maturity of loans to as long as 20 years and limiting debt service to no more than 11 percent of real net revenue (RLR).[7] In the event that debt service obligations exceed the 11 percent limit, the federal government would provide additional loans to cover the excess, and the state would pay back the loan in 10 years. Furthermore, the law stipulated that interest rates would be kept as originally established.

Although states requested that public securities (state Treasury bills and bonds) be included, they were excluded. In fact, both federal and subnational governments were concerned about the rapid growth of public securities and the increasing difficulties of refinancing them in the late 1980s and early 1990s. Constitutional Amendment No. 3 of March 17, 1993, limited the ability of SNGs to issue public securities until the end of 1999. SNGs were only allowed to issue public securities in the amount necessary to refinance the principal indexed by inflation, with one exception related to the issuance of SNG securities to pay for judicial writs.[8]

The third round of debt renegotiations was initiated in 1996. The first and second rounds restructured only part of subnational debt. With a substantial part of SNG debt unresolved and persistent pressures placed on the primary balance, the fiscal and debt position of SNGs continued to deteriorate. As hyperinflation was brought under control, the SNG debt situation worsened, with debt obligations rising in real terms. SNG debt as a share of GDP increased from 9.2 percent in 1993 to 10.7 percent in 1996. The debt service pressures were even more severe. Law No. 9496 of September 11, 1997, authorized the third round of renegotiations by establishing criteria for consolidating, refinancing, and assuming the national debt and other securities held by states and the Federal District. The main difference between this round and the previous two was that a major fiscal consolidation program underpinned the debt renegotiation. Although a bill relating to state debt was passed in 1997, legislation related to municipal debt was enacted only in 1999.

Macroeconomic Stabilization

The decade-long effort to renegotiate subnational debt unfolded within the broader context of national efforts to achieve macroeconomic stabilization and put Brazil onto a more sustainable growth path. The second round accompanied two complementary macroeconomic adjustment programs: the Federal Immediate Action Plan (PAI) in 1993 (box 1.1), which sought to reorganize and reorient the entire public sector including SNGs; and the Real Plan in 1994 (box 1.2), which aimed to control inflation (monthly inflation rates were about 45 percent in the second quarter of 1994). The implementation of these two macroeconomic programs helped shape the direction and substance of the third, and most consequential, round of debt renegotiation.

The main elements of the Real Plan in 1994 included the introduction of a new currency (the real), the de-indexation of the economy, an initial freeze on public sector prices, the tightening of monetary policy, and the floating of the currency, with a floor specified for its value vis-à-vis the dollar. The Real Plan managed to break the vicious cycle of high inflation and to de-index the economy.

Eichengreen (2007) argues that defending a particular exchange rate with capital mobility implies implementing domestic policies aimed at stabilizing the system. In Brazil, it was no different. The monetary policy during the Real Plan sought to maintain exchange rate stability, contributing to the success of the stabilization plan. Thus, in addition to the expected effects on production and consumption associated with a

Box 1.1 The 1993 Federal Immediate Action Plan

The 1993 Federal Immediate Action Plan (PAI) reorganized the public sector by untying earmarked revenues and reducing expenditures. The PAI was based on the assumption that inflation was caused by, among other factors, the financial and administrative disarray of the Brazilian state. The main provisions of the PAI provide for the following:

- Raising tax revenue by implementing a financial transactions tax and efforts to combat tax evasion
- Controlling public spending and using resources more efficiently
- Changing the nature of the relations between the national government and the SNGs, reducing unconstitutional transfers, and restructuring SNG debt
- Restructuring the public banks (both federal and state), which aimed to privatize government shares
- Deepening the privatization process, including the electricity and railroad sectors, and completing the privatization of state-owned enterprises in the petrochemical and steel sectors
- Creating the Emergency Social Fund, which temporarily reduced the share of earmarked revenues at both the federal and subnational levels.

Box 1.2 The Real Plan, 1994

The implementation of the 1994 Real Plan, with the PAI as its backbone, consisted of two steps.

The first step encompassed monetary reform to combat inflation by introducing the real value unit (URV) to disrupt the indexing system of prices and incomes. Implemented on January 3, 1994, the URV followed the daily pro-rata variation of a set of three price indexes. All contracts were to be expressed in the new unit of account. To coordinate the inflationary expectations, the URV was pegged to the dollar. Use of the URV prior to adoption of the new currency was intended to realign relative prices, reduce the redistributive effects, and coordinate agent expectations. On July 1, 1994, the currency reform was completed, transforming the URV into the new currency, the real. The entire money stock was replaced, and the real became the medium of exchange. Wages, in turn, were converted to the new currency, calculated based on the average in URV between March and July.

The second step adopted an anchor with the purpose of coordinating expectations. After a first attempt to use a monetary anchor, it became clear that a stronger instrument was needed to stabilize expectations. The choice fell naturally to the exchange rate. To meet the goal of coordinating inflationary expectations, the exchange rate regime was redesigned three times between 1994 and 1999:

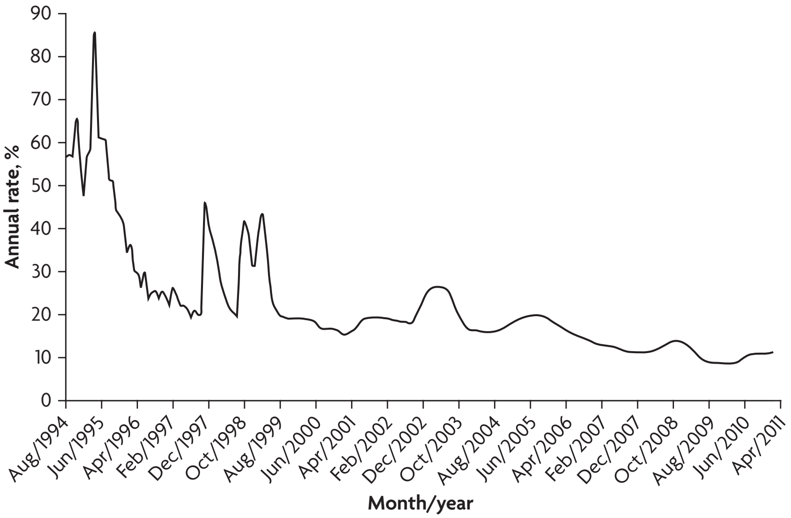
- When the exchange rate targeting regime was adopted, the exchange rate was fixed between October 1994 and February 1995, despite an official system of bands.
- When the Mexican crisis arose in December 1994, the significant reduction in capital flows to emerging markets and the loss of foreign reserves by the central bank led to the adoption of a more widely fluctuating band.
- When the huge appreciation of the real against the dollar became evident, the exchange rate band was systematically adjusted to ensure the gradual devaluation of the real.

Despite the changes, the central bank essentially set the exchange rate during this period, coordinating expectations and preventing the resurgence of inflation. Despite the evidence of excessive valuation, it was believed that a possible devaluation would negatively affect inflation. So even when the system showed signs of exhaustion, the central bank declined to redraft its essence. Only under a speculative attack in early 1999 did the central bank, unable to sustain the parity, drop out.

restrictive monetary policy, higher interest rates also attracted speculative capital in search of greater profitability. As shown in figure 1.2, the Special Settlement and Custody System (SELIC)[9] rate rose to more than 80 percent a year in February 1995.

While the Real Plan focused on price stabilization, the PAI and the Emergency Social Fund (ESF) introduced greater budgetary flexibility, generated proceeds from privatization, and created more sources of revenue. Therefore, the PAI and the ESF helped create the conditions for the primary surpluses obtained by the consolidated public sector in the 2000s (figure 1.3).

Figure 1.2 SELIC Interest Rate in Brazil, August 1994–April 2011



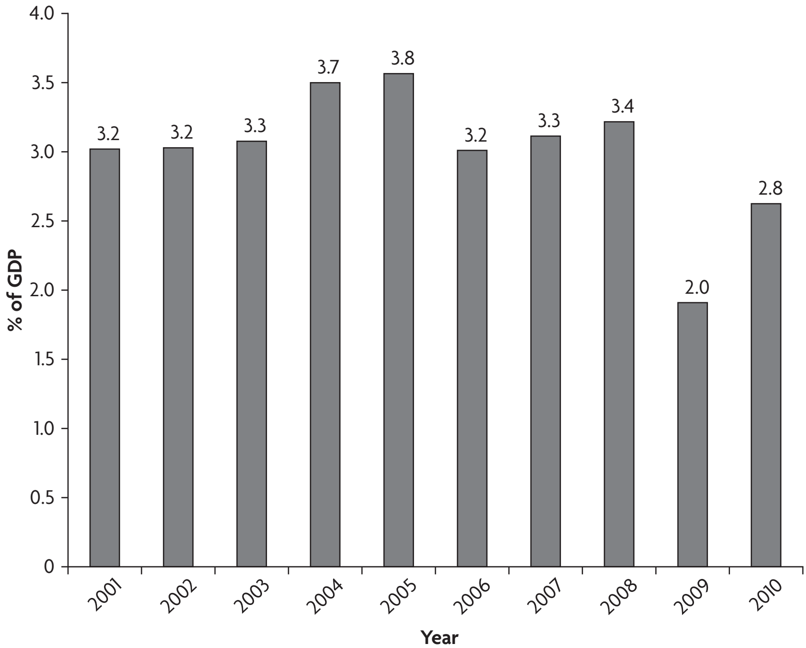
Source: Central Bank of Brazil.
Note: SELIC = Special Settlement and Custody System.

However, the PAI and ESF were insufficient to ensure short-term fiscal balance, partly because a substantial share of SNG debt remained, even after the second round of debt renegotiation.

Following the adoption of the Real Plan, especially during 1995–98, SNGs, particularly the states, began to run primary fiscal deficits (figure 1.4). Importantly, state representatives ended their terms in 1994, while municipal representatives were in the middle of their four-year terms, which implied loose fiscal policy at the state level. Following the political cycle, state public finances worsened, likely due to (a) the end-of-inflation factor (see next paragraph), and (b) the fact that state governments granted generous wage increases at the end of 1994 and especially in 1995, with full financial impact on the following years.

The primary deficits during 1994–98 highlighted the structural imbalance of the SNGs. The sharp reduction in inflation in 1994 removed a public sector instrument that governments at all levels had used to delay payments, which reduced their real value while revenues were indexed. In addition, the rise in interest rates accelerated the growth of state and municipal securities debt, which was charged the

Figure 1.3 Consolidated Primary Fiscal Balance in Brazil, 2001–10

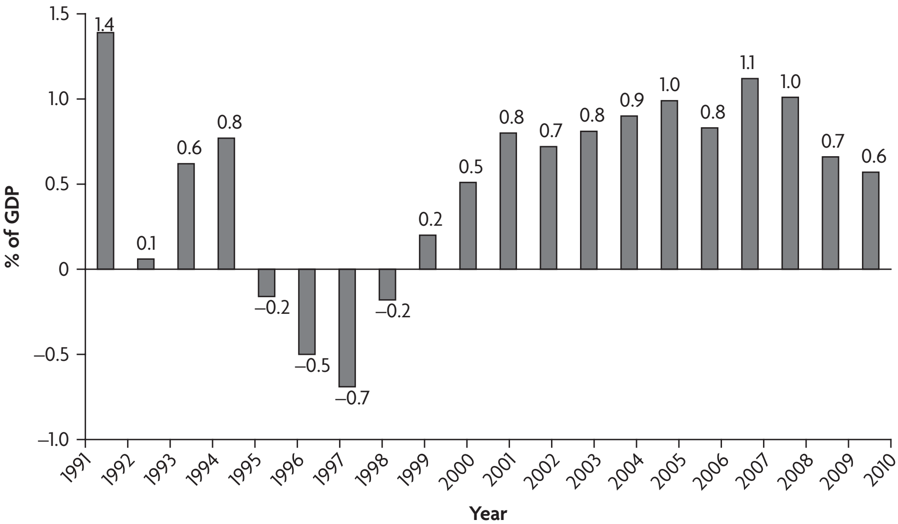


Source: Central Bank of Brazil.
Note: GDP = gross domestic product.

SELIC rate—that is, the growth of securities debt was mainly due to the accumulation of interest on the principal. The primary surplus had to cope with higher interest rates, and aggregate SNG debt reached about 15 percent of RLR in 1995 and 10 percent of RLR in 1996 (Mora 2002).

The majority of state and municipal issuers of public securities, who had serious difficulties generating adequate primary surpluses, could not even afford to pay the interest on the public securities. As a consequence, they began to roll over the entire debt based on federal Senate authorizations,[10] and to use short-term ARO to finance normal budgetary operations. The amounts were large in relation to the fiscal year budget. Even those that could pay at least a portion of interest flocked to the Senate to request the rollover of debt; they had no incentive to reduce their debt. In this context, SNG debt became explosive, requiring a third round of renegotiation that encompassed all the debt stock that had not yet been refinanced.

Figure 1.4 Primary Fiscal Balance of States and Municipalities in Brazil, 1991–2010



Source: Central Bank of Brazil.
Note: GDP = gross domestic product. Does not include state- and municipal-owned companies.

Third Round of SNG Debt Renegotiation and Fiscal Consolidation

The central role of fiscal balance in the design of the Real Plan required SNGs to adhere to federal efforts to stabilize the economy and bring down inflation. Fiscal policy was a key ingredient, and the third round of debt restructuring sought to induce SNGs, particularly states, to generate the primary surplus required to ensure long-term fiscal sustainability and macroeconomic stability.

The renegotiation opened up the possibility that the federal government would give more incentives to SNGs to adopt the principles of the PAI plan (box 1.1). The 1996 renegotiation took place within the context of a discussion of the role of government in the economy. The privatization process at the federal level questioned the prevailing conception of state interventionism. Telecommunications and electricity, until then public monopolies, began to be managed by private companies, subject to regulatory agencies. As a condition for debt refinancing, the states would need to undertake fiscal and financial restructuring, reorienting the role of the government to make it compatible with the changes occurring at the federal level.

In addition, the restructuring programs were aimed at tackling the potential sources of imbalance, in order to create the conditions for the gradual repayment of debt. The contracts between the federal government and the states included a rigorous fiscal and restructuring adjustment program (the Incentive Program for the States' Restructuring and Fiscal Adjustment, PAF),[11] encompassing fiscal targets relating to the following indicators: (a) the ratio of debt to RLR, (b) the primary fiscal balance, (c) the public sector wage bill, (d) own-revenue collection, (e) privatization and concession of public services and utilities, (f) administrative reform, and (g) the ratio of capital expenditures to RLR. The state debt would be indexed to the general price index (General Price Index, Domestic Availability, IGP-DI)[12] and charged an annual interest rate of 6 percent, provided that the state paid 20 percent of the debt within two years. These resources would be obtained by privatizing SOEs.

Refinancing agreements and contracts covered almost all existing debts:

- The total amount renegotiated reached 11.2 percent of GDP and was highly concentrated in the four largest debtors. The states of São Paulo and Rio de Janeiro accounted for 5.9 and 1.7 percent of GDP, respectively. The states of Minas Gerais and Rio Grande do Sul also had significant financial liabilities. These four large debtors absorbed about 90 percent of the amount renegotiated.
- Depending on the initial conditions in each state and the possibility of making an important down payment with proceeds from the privatization of state assets, the terms of the contracts varied: limits on the ratio of debt service to revenue, for example, could vary from 12 to 15 percent. Most of the states signed a 30-year contract, some of which had 15-year terms to maturity. The interest rate in most of the contracts was IGP-DI plus 6–7.5 percent a year.

To fulfill their contractual obligations, state governments conducted a rigorous fiscal adjustment and began to generate primary surpluses. This extensive process of fiscal and financial restructuring also included the following:

- The privatization of SOEs, especially in the electricity sector
- The restructuring and privatization of public banks owned by the states, which adhered to the Incentive Program for the Reduction of Participation of the States in Public Sector Banking
- The reorganization of state public finances, with greater fiscal responsibility.

In addition to spending cuts, states were encouraged to take loans to modernize tax administration, contributing to an increase in tax collection, especially the VAT on goods, intermunicipal transportation, and communications services (ICMS). The ICMS revenue collection also benefited from an increase in the rate levied on the transport, electricity, and telecommunications sectors, characterized by low elasticity of demand. The fiscal adjustment strategy also increased the fiscal space for debt payment. If the states did not fulfill their commitments, the federal government was authorized to withhold transfers from the State Participation Fund (FPE) and even the states own tax, the ICMS.

The PAF and its mechanisms for monitoring and enforcement were critical to the success of the renegotiation. The PAFs, signed by the governors of 25 states,[13] had annual targets for the following three years. Levels of compliance have been high because the debt renegotiation contracts have a specific clause that allows the National Treasury to stop making legal transfers to states that do not comply, and even to sequestrate states' own tax revenue in case of nonpayment of the agreed portion of their debt. Each year the goals and commitments of the previous year are evaluated and the targets updated where appropriate. Targets not achieved are subject to fines. These procedures will follow the refinancing contracts until their discharge.

Therefore, it is reasonable to conclude that after the implementation of the Real Plan, the federal government had a clear interest in renegotiating the state's debt because it was linked to other economic measures such as privatization of public utilities and state financial institutions, and implementation of programs to modernize tax administration at the state level. In addition, considering the macroeconomic context, the debt renegotiation had a crucial impact on improving the solvency and liquidity of the Brazilian banking system: large commercial bank assets which were held against the states (previously classified as high risk) were exchanged for high-yield federal assets (National Treasury bonds).

The negotiation with municipalities was conducted separately starting in 1998. Unlike state debt, municipal debt was not addressed in Law No. 9496 in 1996, because the financial situation of municipalities was far less worrying than that of states. Nevertheless, municipalities such as Campinas, Guarulhos, Osasco, Rio de Janeiro, and São Paulo, which held debt securities, saw their situation worsening, since the assumption of state debt by the federal government meant that municipal securities now had to compete "alone" with federal securities in the market.

Research conducted by the city of Rio de Janeiro[14] indicated that the 50 municipalities with the highest RLR encompassed 29 percent of the population, 55 percent of RLR, and 82 percent of long-term municipal debt. The ratio of debt to RLR on average was 0.72. Only 28 municipalities had a ratio higher than 1. Furthermore, in April 1998, the securities debt of the two capital cities—São Paulo and Rio de Janeiro—constituted 25 percent of total SNG debt still to be renegotiated.[15]

The federal government issued Provisional Measure No. 1891 in January 1999, which extended to the municipalities the general conditions granted to the states without requiring fiscal programs, but tightened restrictions on debt contracting. The main terms of restructuring the municipalities' debt were[16] as follows:

- An interest rate of 9 percent a year, which could be reduced to 7.5 percent a year, or 6 percent a year if the municipality extraordinarily amortized an amount equivalent to 10 or 20 percent of the outstanding balance within 30 months of signing the contract
- Exemption of municipalities from fiscal adjustment programs, which the states were obliged to participate in under the PAF. Around 180 municipalities signed contracts with the federal government restructuring their debt under these new conditions, which affected about 10 percent of all operations with the states. For larger municipalities, the possibility of extraordinary amortization only postponed the imposition of the 9 percent interest rate.[17]

In the macroeconomic sphere, the devaluation of the domestic currency in 1999, amid a currency crisis,[18] implied the end of the exchange rate anchor. This was followed by the adoption of an inflation-targeting regime to shield the Real Plan. When this system was introduced, SNG fiscal accounts were already improving. Still, policy makers wanted to ensure that the changes would be lasting and to avoid any retreat from maintaining fiscal balances. After all, the main objective of the new macroeconomic policy was to stabilize the macroeconomic situation. The introduction of inflation targeting was accompanied by the adoption of a floating exchange rate regime and a vigilant effort to maintain fiscal austerity.

The 2000 FRL and Long-Term Fiscal Sustainability

The success of the Real Plan and the third round of subnational debt restructuring created the economic and political conditions for the approval and implementation of the FRL in 2000.[19] The FRL established fiscal limits and restrictions on key fiscal variables, such as personnel expenditures and debt stock, and defined the responsibility for enforcing the fulfillment of obligations and transparency requirements (see box 1.3). The FRL was essential to strengthening the process of fiscal and financial restructuring of the government, including SNGs, and ensuring long-term fiscal sustainability.

The approval of the FRL was the culmination of a series of key and incremental reforms in which sequencing and pace were critical.[20] Among the most important were the following:

- The creation in 1986 of the National Treasury Secretariat (STN) in the Ministry of Finance, with broad responsibilities for public finances, especially with regard to managing federal assets and liabilities[21]
- The 1988 Constitution, which expanded social responsibilities of the government, particularly for subnationals
- The closing or privatization of state commercial banks in early 1990
- The 1998 Constitutional Amendment No. 19, which established new rules related to public administration and which made public the debate about issues like wage ceilings for public servants and pension systems.

Also, the implementation of the Real Plan strongly influenced the fiscal path to be followed by states and municipalities.

Furthermore, according to Liu and Webb (2011, 10), "Even without a strong party system, a powerful president can enforce subnational fiscal discipline. President Cardoso in Brazil became a strong president in

Box 1.3 The Fiscal Responsibility Law (Complementary Law No. 101, May 4, 2000)

The FRL was part of the efforts to strengthen fiscal institutions. The law applies to the federal government, the states, the Federal District, and the municipalities; the legislature (including the audit courts); the judiciary and the attorney general's office; and to their respective agencies, foundations, and funds. The FRL addresses the following issues:

- *Planning and budgeting.* Besides defining basic parameters for the annual budget bill to be prepared by the executive, the Budget Guidelines Law defines fiscal targets relating to the primary balance and debt, and to rules for fiscal management. It includes a detailed assessment of the government's contingent liabilities. The Multiyear Plan, the Budget Guidelines Law, and the Annual Budget Law must be consistent.
- *Debt.* The FRL presents a detailed definition of consolidated long-term public debt, public securities, credit operations, and guarantees; sets strict provisions on indebtedness and issuance of public debt by the central bank, and prohibits creditor debt-restructuring operations among the various levels of government. In accordance with Article 52 of the Federal Constitution, the Senate passed a resolution establishing limits on indebtedness by level of government. If an SNG is in breach of the debt ceilings, new financing and discretionary transfers to the SNG are banned.
- *Personnel expenditures.* The FRL sets separate ceilings for personnel spending, including pensions and payment of subcontractors. Spending is limited to 50 percent of net current revenues for the federal government and 60 percent for states and municipalities. The law also establishes limits for the executive, legislative, and judicial branches. In case of noncompliance, the jurisdiction will not be allowed to engage in new credit line operations, and SNGs will not be allowed to receive transfers or credit guarantees from the federal government.
- *Control and transparency.* Budget reports and compliance with the limits set by the law must be reported every two or four months. The legislative branch of each level of government, supported by its respective court of accounts, monitors the fiscal targets and ceilings. Procedures for record keeping and consolidation of accounts were significantly improved to reveal compliance with the provisions of the law.

Article 167, Section III, of the Federal Constitution establishes a "golden rule" to prevent the use of borrowing to finance current expenditures: the amount of new loans contracted is limited to the amount of capital expense. Law No. 10028 (October 31, 2000) establishes penalties for public officials not complying with the FRL.

the late 1990s even in the context of weak party loyalties and used his office (and reputation as an inflation fighter, from when he was minister of finance) to press successfully for fiscal discipline at the national and subnational levels."

All of these institutional changes informed the debate and helped the main agents agree to more fiscal responsibility and transparency, which were consolidated in the 2000 FRL. The preparation, discussion, approval, and implementation of the FRL followed a strategy in which all key players—federal and subnational governments, the Parliament, the financial sector, the media, and public finance experts—were educated about the need to change and enforce the framework for public finances in Brazil. The past "traumas" of fiscal distress, especially at the subnational level, also made the agents more open to introducing more controls and limits.[22]

SNG Fiscal Performance after Debt Renegotiation Agreements

Since the first round of negotiations in 1989, the Brazilian economy has undergone profound changes, including a substantial improvement in macroeconomic indicators, especially in the fiscal stance. The institutional reforms allowed, among other things, a new pattern of intergovernmental relations in which states and municipalities were able to achieve sound fiscal outcomes.

As noted, following implementation of the Real Plan, the country adopted an inflation-targeting, flexible exchange rate regime and began to generate significant primary surpluses. Inflation was reduced and has remained below 5.9 percent since 2005. Starting in 2004, the economy experienced solid growth, with annual rates above 5 percent (except in 2009 when GDP fell 0.6 percent). In 2010, following the accumulation of foreign reserves, the public sector became a net creditor in foreign currency. Not only was SNG debt reduced, but federal government debt also fell, from 38 percent of GDP in 2002 to 27.5 percent in 2010.

The rescheduling of SNG debt and the institutional changes that occurred in the post-FRL period led the fiscal adjustment occurring in the past decade. Since the debt renegotiation in 1999 and 2000, the ratio of SNG debt to GDP declined steadily, from more than 20 percent in the beginning of 2000 to around 13 percent in 2010. To assess the factors that contributed to this performance, we examine revenue and expenses during 2000–09.[23] It is critical to examine the consolidated public finance data for both states and municipalities and to include indirect institutions such as SOEs, foundations, agencies, and autarchies.[24] Excluding them runs the risk of underestimating the extent of contingent liabilities.

Fiscal Turnaround: Deficit and Debt Trend

Throughout the first decade of the 2000s, state and municipal finances improved significantly. SNGs generated a primary surplus of about 1 percent of GDP, reversing the deterioration of the previous two decades (table 1.1). The limits imposed by the FRL on public spending, debt, and debt service were crucial to these results. In addition, increases in bank credit operations for the public sector were subjected to controls and limits established by the National Monetary Council.

Total public net debt as a share of GDP declined from 52 percent in 2001 to 39 percent in 2010, with all levels of government showing improvement in this indicator: for the federal government, it declined from 31.7 to 26.4 percent; for states, from 18.1 to 11 percent[25]; and for municipalities, from 2.2 to 1.8 percent (figure 1.5). These improvements were the result not only of GDP growth, but also of rising tax revenues and declining ratios of SNG net debt to GDP (figure 1.6).

States have benefited significantly from the increase in revenues occurring after 1998. This is due in part to the fact that ICMS collection has been positively affected by higher taxes on certain products, such as telephony in several states; to the higher prices of petroleum products generally; and to improved tax collection efficiency (see Giambiagi 2008). Municipalities experienced a substantial real increase in tax revenues, particularly the tax on services (ISS). Total municipal tax revenues increased 50 percent over inflation from 2001 to 2010. The ISS grew 105 percent during the same period, while national GDP grew 40.7 percent.

The reduction in state public debt can also be assessed by the ratio of net debt to net current revenue. This ratio was greater than 1 in 17 states in 2000, but in only 7 states in 2010. States with the majority of SNG debt, such as São Paulo and Rio de Janeiro, lowered their ratio of debt to net current revenue, respectively, from 1.9 and 2.1 in 2000 to 1.5 and 1.4 in 2010. In general, SNG budgetary execution became stronger, and the burden of debt service became looser. As seen earlier, the distribution of state debt is highly concentrated, favoring the richer states, which were the major beneficiaries of the debt renegotiation process. The three richest states—São Paulo, Minas Gerais, and Rio de Janeiro—accounted for about two-thirds of total debt in 2009 (table 1.2).

Like state debt in Brazil, municipal debt is also highly concentrated. The four state capitals and five cities with medium and large populations

Table 1.1 Public Sector Borrowing Requirements (PSBR) in Brazil, 1999–2010[a]
% of GDP

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Consolidated nominal balance[b]	5.3	3.4	3.3	4.4	5.2	2.9	3.6	3.6	2.8	2.0	3.3	2.6
States and municipalities[c]	3.2	2.0	2.0	3.8	1.5	1.8	0.2	0.6	0.5	1.2	–0.1	1.3
State governments	2.7	1.8	1.9	3.2	1.2	1.4	0.2	0.4	0.5	1.0	–0.1	1.1
Municipal governments	0.5	0.3	0.1	0.5	0.2	0.3	0.0	0.1	0.1	0.2	0.0	0.2
Consolidated nominal interest[c]	8.2	6.6	6.7	7.7	8.5	6.6	7.4	6.8	6.1	5.5	5.4	5.3
States and municipalities[d]	3.4	2.7	3.0	4.7	2.5	2.8	1.4	1.6	1.7	2.3	0.7	1.9
State governments	2.9	2.3	2.7	4.0	2.1	2.4	1.1	1.4	1.4	1.9	0.5	1.6
Real interest	n.a.	n.a.	n.a.	0.3	1.1	0.7	0.8	0.8	0.5	1.0	0.5	0.6
Monetary correction	n.a.	n.a.	n.a.	3.8	1.0	1.7	0.3	0.5	0.9	1.0	0.0	1.1
Municipal governments	0.5	0.4	0.4	0.7	0.4	0.4	0.2	0.3	0.2	0.3	0.1	0.3
Real interest	n.a.	n.a.	n.a.	0.2	0.2	0.2	0.2	0.2	0.1	0.2	0.1	0.1
Monetary correction	n.a.	n.a.	n.a.	0.5	0.1	0.2	0.0	0.1	0.1	0.2	0.0	0.2
Consolidated primary balance[b]	–2.9	–3.2	–3.4	–3.2	–3.3	–3.7	–3.8	–3.2	–3.3	–3.4	–2.0	–2.8
States and municipalities[c]	–0.2	–0.6	–1.1	–1.0	–1.0	–1.0	–1.1	–1.1	–1.1	–1.1	–0.8	–0.6
State governments	–0.2	–0.5	–0.8	–0.8	–0.9	–0.9	–0.9	–0.9	–1.0	–0.9	–0.6	–0.5
Municipal governments	0.0	–0.1	–0.3	–0.1	–0.1	–0.1	–0.2	–0.1	–0.2	–0.2	–0.1	–0.1

Source: Central Bank of Brazil.

Note: GDP = gross domestic product. n.a. = not applicable.

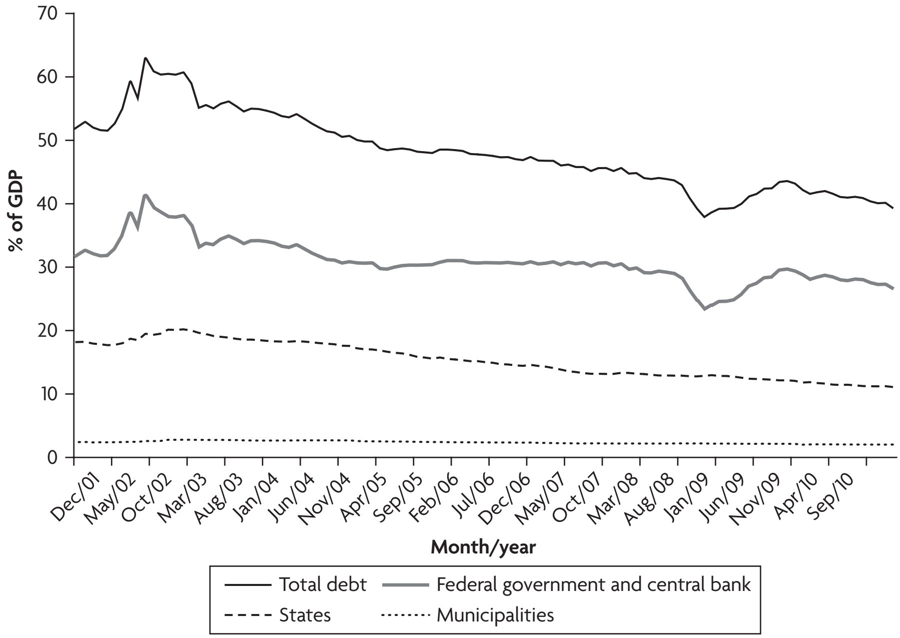
a. Includes federal companies Petrobrás and Eletrobrás during 1999–2001, not affecting data for states and municipalities.

b. Surplus in terms of PSBR concept.

c. Includes companies.

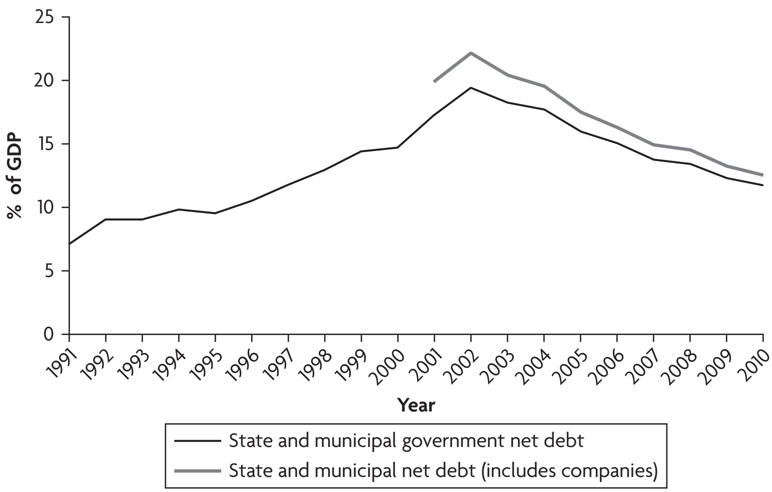
d. The breakdown of monetary correction/real interest for SOEs is not available, so the total amount of nominal interest was added to monetary correction.

Figure 1.5 Net Public Debt in Brazil, 2001–10



Source: Central Bank of Brazil.
Note: GDP = gross domestic product.

Figure 1.6 Net Debt of States and Municipalities in Brazil, 1991–2010



Source: Central Bank of Brazil.
Note: GDP = gross domestic product.

Table 1.2 Share of GDP, Population, and Long-Term Debt of Borrower States in Brazil, 2009

State	% of GDP[a]	% of population[a]	% of states' long-term debt, 2009[b]
São Paulo	33.1	21.6	38.5
Minas Gerais	9.3	10.5	14.3
Rio de Janeiro	11.3	8.4	12.9
Rio Grande do Sul	6.6	5.7	9.4
Goiás	2.5	3.1	3.2
Bahia	4.0	7.6	2.4
Alagoas	0.6	1.6	1.6
Mato Grosso do Sul	1.1	1.2	1.6
Other states	31.5	40.2	16.1
Total	100.0	100.0	100.0

Sources: STN; Federal Institute of Geography and Statistics (IBGE).
Note: GDP = gross domestic product.
a. GDP and Population: 2008.
b. Long-term debt stock on December 31, 2009.

(which are home to 13.9 percent of the total population and generate 22.5 percent of GDP) account for 84.2 percent of long-term public debt and around 20 percent of judicial writ debt (table 1.3). The Municipality of São Paulo alone accounts for two-thirds of the total. In general, the liabilities from judicial writs are greater for municipalities than for states. Currently, municipal debt with tax and legal or judicial obligations in arrears contributes 9 percent of the outstanding balance of long-term debt, while judicial writs account for 27.7 percent.

State Revenues and Expenditures

The improvements experienced in the 2000s in state deficits and debt were the result of strong revenue growth and the consolidation of expenditures. On the revenue side, the growth of states' own revenue surpassed the growth of real GDP by 30 percent, contributing to a generally upward trend in the ratio of total revenue to GDP, as shown in table 1.4, which also identifies the source of revenues.[26]

The volatility of the main sources of budgetary revenues (including loans and other credit operations) is worth considering because it helps explain why investments are unstable at the subnational level (figure 1.7).

Table 1.3 Share of GDP, Population, and Long-Term Debt of Municipalities in Brazil, 2009

Municipality/state	% of GDP[a]	% of population[a]	% of municipal long-term debt, 2009[b]
São Paulo/SP	11.8	5.8	63.3
Rio de Janeiro/RJ	5.1	3.3	11.0
Campinas/SP	1.0	0.6	2.4
Belo Horizonte/MG	1.4	1.3	2.1
Salvador/BA	1.0	1.6	2.0
Guarulhos/SP	1.1	0.7	1.4
Contagem/MG	0.5	0.3	0.8
Joinville/SC	0.4	0.3	0.7
Mauá/SP	0.2	0.2	0.5
Other municipalities	77.5	86.1	15.8
Total	100.0	100.0	100.0

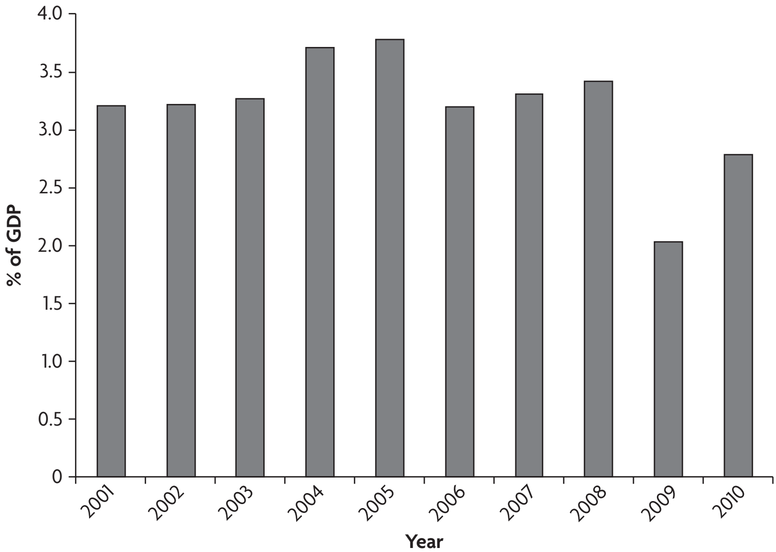
Sources: STN; IBGE.
Note: BA = Bahia, GDP = gross domestic product, MG = Minas Gerais, SP = São Paulo.
a. GDP and Population: 2008.
b. Long-term debt stock on December 31, 2009.

Table 1.4 State Revenue in Brazil, 2000–09
% of GDP

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total revenue	12.9	12.7	13.1	12.4	12.5	13.0	13.0	12.7	13.2	13.2
Taxes	7.8	8.2	8.1	8.1	8.2	8.4	8.3	8.2	8.6	8.5
ICMS	6.7	7.1	7.0	6.9	7.0	7.1	7.0	6.9	7.2	7.1
Other taxes	1.0	1.1	1.2	1.2	1.2	1.3	1.3	1.3	1.4	1.5
Grants from other governments	2.5	2.6	2.9	2.3	2.4	2.6	2.7	2.6	2.8	2.6
Current grants	2.4	2.5	2.6	2.2	2.3	2.6	2.6	2.5	2.7	2.5
Capital grants	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.2
Credit operations	0.3	0.1	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.4
Sale of assets	0.7	0.1	0.1	0.1	0.0	0.1	0.1	0.1	0.0	0.1
Miscellaneous revenues	1.7	1.6	1.8	1.8	1.7	1.8	1.7	1.7	1.6	1.6

Sources: STN; state financial statements; IBGE.
Note: GDP = gross domestic product.

Figure 1.7 Main Sources of State Revenues in Brazil, 2000–09 (2000 = 100)



Source: STN.

During the 2000s, states' own taxes and current grants from the federal government grew steadily until 2009 and the onset of the global financial crisis (figure 1.7). States' own taxes collected grew 7 percent on average annually.[27] The ICMS represented more than 80 percent of states' own tax revenues. The growth in ICMS was partially due to the growth of sectors such as telecommunications, and to the price of petroleum-related products, in addition to the states' efforts to improve tax collection.

Current grants from the federal government increased 36.2 percent during 2000–09 as a result of the decentralization of the provision of health services and the expansion of the FPE, through which 21.5 percent of the federal income tax and the value-added tax on industrialized products (IPI) is granted to the states.[28] During 2000–09, the FPE increased its share of current transfers from 48.4 to 56.9 percent. Although benefiting a few oil-producing states such as Rio de Janeiro, the rise in oil prices brought a large increase in the federal transfer of royalties. Total transfers were almost twice as high in 2008 as they were in 2003.

The sources of budgetary revenue directly related to investments—capital grants and credit operations—declined until 2007 (figure 1.7). Capital grants generally are not mandatory and may be restricted by the targets set by the federal government,[29] while current transfers are totally earmarked to specific social areas, leaving no margin for additional capital investments. In addition, credit operations are subject to limits on total public borrowing set by the central bank. From 2007 onward, both sources began to expand, even after the world financial crisis. The improved macroeconomic conditions and fiscal performance allowed the states to raise new debt while reducing their ratio of debt to revenue.

On the expenditure side, the FRL limits personnel expenditures to no more than 60 percent of net current revenue. The reduction in personnel expenditures and the simultaneous increase in revenue (especially current revenue) improved this ratio: in 2000, 13 states were over the 60 percent limit compared with only a few states in 2009, reflecting a temporary deterioration caused by the global financial crisis. The control of wage bill outlays, together with the reduction in investments[30] as a percentage of primary revenue, allowed states to obtain primary surpluses to fund their debt service. In addition, as a result of the reduction in debt stock, debt service fell as a share of GDP, from 1.2 percent in 2000 to 1 percent in 2009.

Debt service in a given year may not include the total debt service incurred that year, since the debt renegotiation agreements placed a limit on the ratio of debt service to net current revenue. The major borrowers may have been accumulating residual amounts of debt service, which they capitalized as part of the debt stock, according to the debt renegotiation contracts. Table 1.5 presents expenditures as a share of GDP during the 2000s. The increase in grants to municipal governments was due not only to the growth in tax revenue, but also to the creation of a financial fund for education services.[31]

At the subnational level, investments are highly dependent on fiscal year current surpluses and eventual revenues from the sale of assets, which makes them susceptible to the economic cycle. Besides that, new administrations generally follow a political cycle, cutting current (mainly capital) expenses as soon as they take office and increasing spending at the end of their term.[32] For example, in 2003 and 2007, new

Table 1.5 State Expenditures in Brazil, 2000–09
% of GDP

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total expenditure	12.9	13.0	13.4	12.5	12.5	12.9	13.1	12.4	12.9	13.3
Personnel	5.8	5.8	6.1	5.8	5.6	5.7	5.8	5.6	5.5	5.7
Public servants	3.7	3.7	3.4	3.3	3.1	3.2	3.3	3.3	3.3	3.4
Retired/pensions	1.9	1.8	2.1	2.0	1.9	1.9	1.9	1.8	1.8	1.8
Other personnel expenses	0.2	0.3	0.6	0.6	0.6	0.6	0.6	0.5	0.4	0.5
Grants to other governments	2.0	1.9	2.4	2.2	2.3	2.4	2.2	2.3	2.5	2.5
Investments + acquisition of financial assets	1.4	1.3	1.3	0.9	1.0	1.1	1.2	1.0	1.3	1.5
Debt service	1.2	1.1	1.1	1.1	1.0	1.0	1.1	1.0	1.0	1.0
Miscellaneous expenses[a]	2.5	2.8	2.4	2.5	2.6	2.7	2.8	2.5	2.6	2.7

Sources: STN; state financial statements; IBGE.
Note: GDP = gross domestic product.
a. Goods and services/social security transfers.

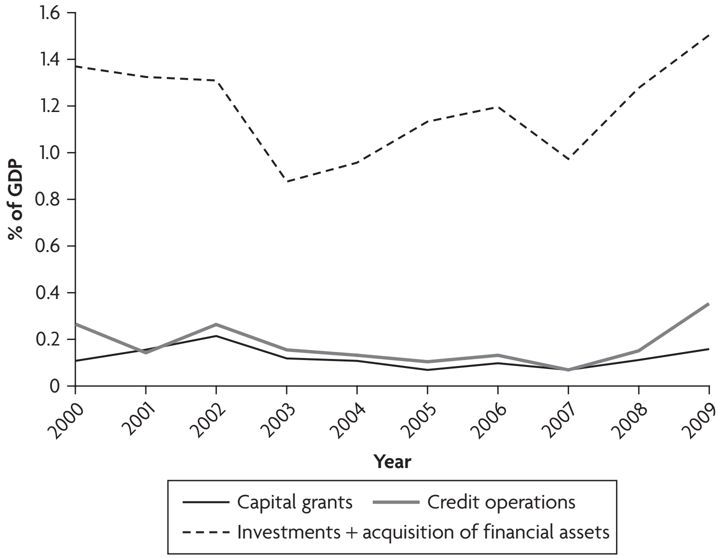
administrations took power, which helps explain the relatively small amount of investments. During the 2008–09 global financial crisis, investments rose sharply due mainly to the expansion of capital grants and credit operations as part of countercyclical macroeconomic policies (figure 1.8). In 2009, the National Bank of Economic and Social Development offered federal loans to states to fund critical projects in the Federal Program for Growth Acceleration.[33]

Municipal Revenues and Expenditures

Unlike the states, which generated a primary surplus in the early 2000s only after the third round of debt renegotiation, municipalities began to generate primary surpluses in 1997. This was an inaugural year of new municipal administrations, when expenditures are generally lower. The primary balance increased during 1999–2001, when debt renegotiations took place, and remained positive in the following years.

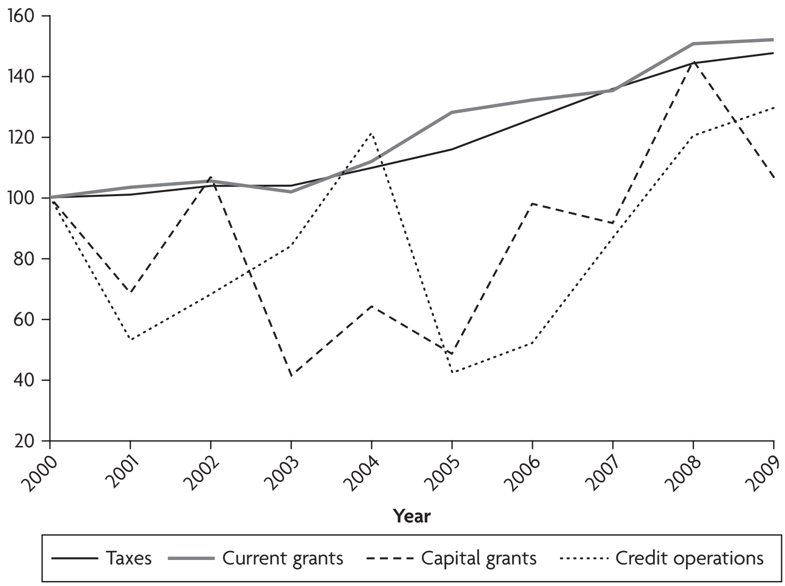
Municipal revenues increased substantially during 2000–09 (figure 1.9). Tax collection grew at an annual average rate of 4.4 percent. Since 2004, the ISS has been growing no less than 10 percent per year in real terms, with the exception of 2009, which was during the global financial crisis, when the rate (still) was 3.3 percent higher than in the previous

Figure 1.8 Main Sources of Investment Financing for States in Brazil, 2000–09



Source: STN.

Figure 1.9 Main Sources of Revenue for Municipalities in Brazil, 2000–09 (2000 = 100)



Sources: STN; municipal financial statements; IBGE.

year. Faster economic growth, changes in legislation, and modernization of tax management contributed to this improvement. Grants from the federal and state governments, by far the major group, increased during 2000–09, at an average rate of 4.8 percent per year. During the period, municipalities counted on additional resources for education (the FUNDEF and the Fund for Maintenance and Development of Basic Education and Teacher Training), and for health, since the provision of health services was decentralized.

The composition of expenditures was relatively stable, consisting mainly of personnel and other miscellaneous expenses, most of which are current expenses incurred for the provision of services. Table 1.6 identifies the main items of expenditure. It also includes a memorandum item—the ratio of personnel expenses to net current revenues—that remained relatively stable throughout the period of analysis, with a slight increase in 2009. Figure 1.10 highlights the major municipal expenditures for this period.

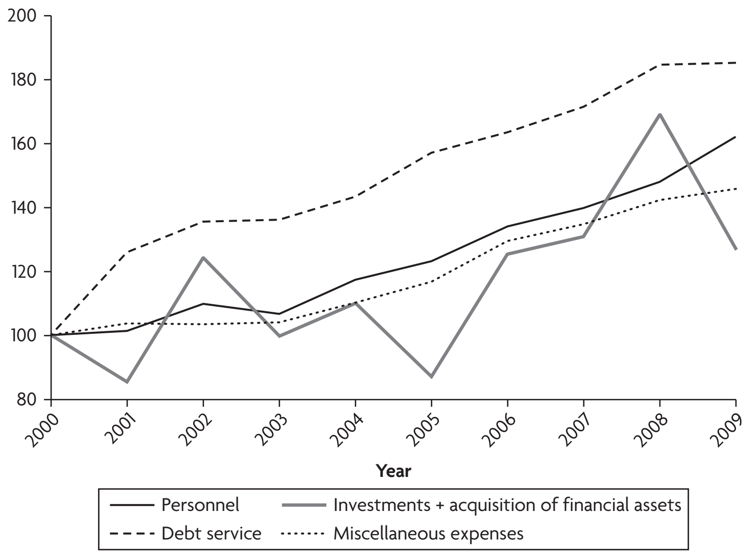
At the local level, the political cycle explains the smaller share of investments in total expenditures in the initial years of a new administration, as occurred in 2001 and 2005. The ratio of investments to total

Table 1.6 Expenditures of Municipalities in Brazil, 2000–09
% of GDP

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total expenditure	7.0	7.0	7.4	7.0	7.2	7.1	7.7	7.6	7.8	8.0
Personnel	3.0	3.0	3.2	3.1	3.2	3.3	3.4	3.3	3.4	3.7
Public servants	2.3	2.3	2.3	2.3	2.3	2.3	2.4	2.4	2.4	2.6
Retired/pensions	0.3	0.3	0.4	0.3	0.3	0.3	0.3	0.3	0.4	0.4
Other personnel expenses	0.4	0.4	0.6	0.5	0.6	0.6	0.7	0.6	0.6	0.7
Investments + acquisition of financial assets	0.8	0.7	1.0	0.8	0.8	0.6	0.9	0.9	1.1	0.8
Debt service	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Miscellaneous expenses[a]	2.9	3.0	2.9	2.9	2.9	3.0	3.2	3.1	3.1	3.2
Memo										
Personnel/NCR (%)	43.1	42.1	43.5	44.8	43.2	41.3	42.8	42.8	41.7	45.6

Sources: STN; municipal financial statements; IBGE.
Note: GDP = gross domestic product, NCR = net current revenue.
a. Goods and services/social security transfers.

Figure 1.10 Main Expenditures of Municipalities in Brazil, 2000–09 (2000 = 100)



Sources: STN; municipal financial statements; IBGE.
Note: GDP = gross domestic product.

expenditures was 10 percent in 2001, rising to an average of 12 percent during the three remaining years of the term. In 2005, the ratio fell to 8.8 percent, recovering to an average of 12 percent in the remaining years of 2005–08 administrations. The lower ratio of debt to revenue results in a lower burden of debt service, which averaged 0.26 percent of GDP during 2000–09. The ratio of debt service to net current revenue, per the FRL target, averaged close to 3.5 percent. Debt service may not include the total amount incurred in the year, since limits are placed on payments to net current revenue. The sharp increase in debt service is a "base effect," however, because the municipal debt renegotiations took place mainly during 1999–2000, and debt payments were resumed in 2001, with the National Treasury as the major creditor.

To sum up, during 2000–09, except for some specificities such as the growth of debt until 2003, public sector borrowing requirements, debt, and personnel expenditures improved steadily. Growth in revenue and control of personnel expenses, particularly in the states, strengthened the fiscal accounts of SNGs, and this improvement was fundamental to tackling the crisis of 2008–09.[34] One important lesson is that the subnational fiscal framework, which was established at the end of the 1900s with the debt renegotiations, has not only allowed SNGs to improve their fiscal stance, but has also shown a strong resilience and a reasonable level of flexibility, overcoming without major changes two economic downturns. First, during 2001–03, right after enactment of the FRL, Brazil faced an energy supply crisis (especially electric power), which had a significant impact on economic developments, and a market confidence crisis associated with the 2002 election. Second, the fiscal framework also stood firm during the 2008–09 global financial crisis, which is analyzed in the next section.

Impact of the Global Financial Crisis and Challenges to Subnational Fiscal Sustainability

Brazil showed strong resilience during the 2008–09 financial crisis. Blanco, Barbosa Filho, and Pessôa (2011) conclude that Brazil's adoption of far-reaching structural reforms and price stabilization initiatives in the 1990s, followed by the consistent pursuit of sound macroeconomic policies in the 2000s, strengthened the country's resistance to external shocks.

Nevertheless, the global financial crisis affected the Brazilian economy and state and municipal finances. The immediate and perhaps most important impact was on financial markets—a reduction in external credit and a sharp depreciation of the domestic currency. The downturn in economic activity in the world's major economies had a significant impact on the price of commodities exported by Brazil: exports fell 10.2 percent in 2009 compared to 2008, reducing tax revenue, particularly the ICMS of exporter states.

The government's active management of macroeconomic policies—fiscal, monetary, and external policies, in particular—mitigated the effects of the crisis. After contracting 0.3 percent in 2009, real GDP rebounded in 2010, growing 7.5 percent and, because of the continuation of the global economic crisis, economic growth slowed in 2011 with GDP increasing only 2.7 percent. Inflation increased to around 6 percent a year but is still close to the upper band of the inflation targets defined by the central bank. Gross official reserves recovered, and credit to the private sector returned to trend levels in 2010.

The decline in economic activity and the implementation of a set of tax exemption measures aimed at sustaining aggregate household consumption led to a fall in tax revenue in 2009. Tax as a share of GDP declined from 34.4 percent of GDP in 2008 to 33.6 percent in 2009, as GDP contracted 0.6 percent and total tax collection fell almost 3 percent. The federal government increased its spending on salaries for civil servants and raised the minimum wage, affecting the payment of pension benefits. As a consequence, the consolidated primary fiscal surplus fell to 2 percent of GDP in 2009, well below the average level of 3.5 percent during 2004–08. Inflation as measured by IGP-DI declined 1.4 percent in 2009, reducing the nominal interest rate and the need for public sector borrowing.[35]

The countercyclical fiscal policy included many measures that supported state and municipal revenues: (a) an increase in capital grants due to federal investments programmed under the Federal Program for Growth Acceleration; (b) a reduction in income tax collection and cuts in the IPI tax, which helped support the auto industry, prevent job losses, and reduce SNG transfers through the FPE and Municipalities Participation Fund; (c) compensation for the loss of current grants—states received additional credit lines from the National Bank of Economic and Social Development to keep investments and to match federal capital transfers related mainly to the Federal Program for Growth Acceleration; and (d) receipt by municipalities of general grants to keep the amounts transferred from the Municipalities Participation Fund the same as in 2008. Public banks expanded the supply of credit to help exporters finance their costs in foreign currency and to help corporations and consumers offset the decline in private credit.[36]

Impact of the Crisis on States and Municipalities

The impact of the crisis differed across states and municipalities and across participants in each group. It is necessary to examine the impact not only of the crisis but also of federal policies to offset the economic downturn.[37]

The immediate impact of the economic downturn on the fiscal accounts of states was to reduce ICMS collection and transfers from the FPE, the latter due to the decrease in federal revenues from the income tax and tax on industrialized products. For all the states, these two sources of revenue have represented around 50–70 percent of disposable income (after transfers to municipalities).[38] The impacts of the global crisis on state finances began to be felt only in late 2008 and were not enough to erase the revenue gains in 2007 and most of 2008:

- In 2008, the ICMS, the main source of states' own revenues, grew at an average real rate of 9.5 percent compared with 3 percent in 2007 (8 out of the 27 states had increases over 10 percent). FPE transfers from the federal government performed even better, increasing 12.9 percent compared with 3 percent in 2007 (uniform for all the states). In 2009, the reduction in revenues from the ICMS (2.5 percent as a national average) and in the FPE (8.9 percent) was only a reduction relative to the excellent performance of 2008. In 2010, the ICMS tax collection had recovered to its precrisis level.
- Fiscal indicators for a sample of 10 states during 2007–09 confirm these results.[39] In 2009, all but one state in the sample had revenue losses compared with 2008, but they were in a stronger position than in 2007 as measured by net current revenue (RCL).[40] The investment boom during 2008–09 was stupendous. In 2007, investments were financed mostly by "other internal sources," which included the current surplus (after payment of debt service). The expansion of investments was an important element in the expansion of capital grants and credit operations, although the composition of sources differed among states. The federal government, through National Monetary Council resolutions, provided additional resources to states through loans to compensate the loss of transfers from the FPE. The increase in funds raised through new indebtedness was small compared with the outstanding stock of debt; thus, the ratio of net debt to net current revenue was not seriously affected. Total credit granted in 2009 was about 2.5 percent of the outstanding contractual debt at the end of 2009. Moreover, the growth in net current revenue and decline in the IGP-DI helped reduce the ratio.[41]

The impact of the global crisis was less intense on municipalities than on states. While states generally lost current revenues during 2008–09, municipalities were able to offset the losses from ICMS transfers through increases in other transfers and own taxes. Fiscal indicators for a sample of six municipalities (Belo Horizonte, Cuiabá, Porto Alegre, Rio de Janeiro, Salvador, and São Paulo) show that in 2009, total revenue remained constant, mainly due to the following factors:

- The property tax and the tax on services grew faster than inflation (5 and 3.3 percent, respectively), allowing total tax revenue to grow in real terms.
- The federal transfers targeted to health services increased 10.2 percent in real terms, compensating the slight real reduction (0.5 percent) in other current transfers.
- The federal government adopted a policy of using voluntary transfers to compensate the loss of transfers from the Municipalities Participation Fund (around 25 percent of current grants), in order to maintain the nominal amount received by each municipality during the previous year.
- The resources of the Fund for Maintenance and Development of Basic Education and Teacher Training grew largely as a result of state contributions.

In contrast to state investments, municipal investments, as reflected by investments of the six capital cities, either decreased or grew just slightly in 2009.[42] In addition, the stability of revenues resulted in a stable ratio of personnel expenses to net current revenue.

Challenges to Subnational Fiscal Sustainability

The fiscal performance of Brazil's SNGs during the last decade was impressive. However, SNGs are facing challenges that may have an impact on their long-term fiscal sustainability. Here we highlight three issues that bear a more immediate relationship to the debt restructuring framework discussed in previous sections:[43] (a) the indexation rules for debt that was renegotiated at the end of 1990s and the accumulation of residuals, (b) the narrow fiscal space and low current public investment, and (c) the potential for reducing debt service cost through more competitive subnational credit markets. We deal with each in turn.

As noted, the SNG debt renegotiation indexed the subnational debt to the IGP-DI, plus a "real" interest rate of about 6 percent. This arrangement was reasonable at the time of the renegotiation because of the then prevailing macroeconomic conditions. The interest rate (or the SELIC rate, which is the basic funding cost of the federal government) was much higher than the conditions agreed. The exchange regime had a fixed exchange rate, and the inflation targeting regime was not yet part of the monetary instruments. Finally, there was no umbrella fiscal law, like the FRL, establishing fiscal limits and conditions. Now, the macroeconomic context has changed with new, improved mechanisms such as a floating exchange rate, and inflation-targeting regimes resulting in a higher level of macro stability. More important, the SELIC rate has steadily declined, especially since the global economic crisis, and the cost of the renegotiated contracts is much higher than the basic interest rate in the domestic economy. As a result, states would like to refinance their debt in the market, but the contracts forbid doing so.[44]

The state authorities have initiated negotiations in the Congress in the hope of changing the conditions of the original contracts. The IGP-DI is highly volatile, however, and therefore not a good reference for the asset and liability management of federal and SNG governments. A related challenge that is derived from the debt renegotiation contracts is the 13 percent cap on net revenues. Although this cap is a good countercyclical feature, which was useful for the most indebted states, it has generated a residual in several states—building up capitalized interest, which is a potentially serious financial problem. According to the legislation, this residual must be repaid in 10 years starting in 2030. The residuals also depend on GDP growth and the trend of the IGP-DI. For some states, such as Rio de Janeiro, residuals could disappear if GDP growth averages 4 percent during 2010–20 and the IGP-DI converges to inflation (according to Levy 2009). Official projections for the Municipality of São Paulo estimate that if the growth of net current revenue is about 1 percent per year, the ratio of debt to net current revenue will be about 327 percent in 2030, and the ratio of debt service to net current revenue may reach 51 percent, indicating an unsustainable path (according to Prefeitura da Cidade de São Paulo 2011).

The narrow fiscal space and the various regulations for new indebtedness have posed challenges in financing public investments at the subnational level. The brunt of SNG fiscal adjustment has fallen on public investments, resulting in a deterioration in infrastructure and threatening economic growth. While the limits imposed on SNG debt financing as part of the fiscal adjustment program have been successful in turning around the SNG fiscal imbalance, a challenge ahead is to identify ways of increasing infrastructure investments and finance while maintaining fiscal discipline. In the long term, economic growth is a key determinant of fiscal sustainability.

Finally, another challenge is to develop competitive credit markets for subnational public investments. More competitive subnational credit markets help lower the cost of financing and extend maturity. Cost of financing is another key determinant of fiscal sustainability. Canuto and Liu (2010) show that the subnational debt market in developing countries has been undergoing a notable transformation. Private capital has emerged to play an important role in subnational finance in countries such as Poland, Romania, and South Africa. Subnational bonds increasingly compete with traditional bank loans. Notwithstanding the temporary disruption of credit markets during the crisis, the diversification of subnational credit markets is expected to continue. SNGs or their entities in various countries have already issued bond instruments (for example, in China, Colombia, India, Mexico, Poland, the Russian Federation, and South Africa). More countries are considering policies to foster the development of subnational debt markets (for example, Indonesia and South Africa), while others are piloting transaction and capacity-building activities to the same end (for example, Peru). Competitive financial markets, with a variety of buyers and sellers and a variety of financial products, can keep borrowing costs down.[45]

In Brazil, public financial institutions are currently the primary providers of credit to SNGs.[46] As part of debt restructuring, SNGs have been prohibited from issuing bonds. This has helped bring subnational debt onto a more sustainable path. Looking forward, a key challenge is to identify ways of increasing competition in the subnational credit market to reduce the cost of financing and help fiscal sustainability in the long term. International experience shows that prudent regulatory frameworks for subnational capital markets are important to manage the risks of defaults, and the process of developing such frameworks is gradual and incremental.

Conclusions

The SNG debt crisis in Brazil was the result not only of autonomous decisions by the SNGs, but also of decisions by the federal government to implement economic development plans amid financial internal and external constraints, mainly during the authoritarian political regime of 1964–85. The SNGs had an important role in both attracting external resources that eased the pressure on external accounts and implementing large projects to accelerate urbanization. Coupled with the external fundraising of SNGs—led by central government macroeconomic policy—the recourse to borrowing was a way to circumvent the strict controls on fiscal management, with a strong negative effect on the fiscal accounts of SNGs, particularly the states.

The control of subnational borrowing in the form of debt renegotiation agreements in 1997 imposed strict rules on the financial and fiscal management of SNGs and assured their adherence to the guidelines set by the federal government for the conduct of macroeconomic policy. The latest round of renegotiations during 1997–2000 paved the way to macroeconomic stability.

Building on the success of the Real Plan, in 1999 Brazil adopted a regime of inflation targeting and flexible exchange rates and initiated a strong fiscal adjustment program that generated significant primary surpluses. Inflation was reduced and has stayed below 5.9 percent since 2005, partly explained by the strong expansion of imports at progressively lower prices due to the appreciation of the Brazilian currency during 2003–10. Starting in 2004, the Brazilian economy began a sustained path of economic growth. Brazil was resilient in the face of the 2008–09 global financial crisis, owing to the combination of sound macroeconomic management and a highly favorable external scenario throughout the 2000s (except for the international liquidity crisis in 2009). Both SNG and federal government debt levels were reduced, with federal government debt falling from 38 percent of GDP in 2002 to 26.4 percent in 2010. Following the accumulation of reserves, the public sector became a net creditor in foreign currency. The country achieved trade surpluses, mainly between 2005 and 2007, averaging US$43.7 billion a year.

The country's institutional consolidation and modernization, resulting in approval of the Fiscal Responsibility Law in 2000, is crucial to understanding the trajectory of relative fiscal consolidation and reduction in the ratio of debt to GDP achieved in the last 11 years. However, the institutional reforms do not end with approval of the FRL. The FRL principles, procedures, and requirements would be ineffective if not followed by other initiatives such as continued efforts to improve rules and procedures for registering and reporting on public accounts and the adoption of uniform criteria to demonstrate compliance with legal limits. These efforts have given more credibility to financial statements, particularly from SNGs.

This chapter shows that in all government spheres—federal and subnational—fiscal adjustments and consolidation have been greatly facilitated by the growth of government tax revenue. Since the debt restructuring, almost all states and a large number of municipalities have been modernizing their tax administration. Revenue growth, however, has not translated into expanded public investment, leaving urgent projects in urban infrastructure with insufficient funding. In contrast, the provision of basic public services has expanded—increasing the coverage of health services and education, for example—but this has increased the need to fund higher current expenditures.

Notwithstanding the success of fiscal reform and debt restructuring, Brazilian SNGs face challenges that may impact the sustainability of subnational finance and economic growth. The three challenges that have more direct bearing on debt restructuring are the indexation rules and potential accumulation of residuals, narrow fiscal space to finance the public investment gap and its impact on economic growth, and the need to foster competitive subnational credit markets for lowering financing costs for public investments.

Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

1. Brazil is a federal republic, encompassing a federal government (the union), 26 states, a Federal District (Brasília), and 5,564 municipalities. Ranked fifth in world population, Brazil had 191 million inhabitants in 2010. States and municipalities vary greatly in size. Unless otherwise indicated, the states include the Federal District.
2. Serra and Afonso (2007) remind us that the federative framework in Brazil is a system that is still evolving and point out main aspects in terms of vertical and horizontal decentralization and government powers.

3. The restrictive fiscal policy and reduced reliance on imports as a result of investments made during 1974–79 (the second National Development Plan), coupled with the world economic recovery, allowed GDP to grow 5.4 percent in 1984 and around 4.5 percent in 1985 and 1986 (Giambiagi et al. 2005).
4. Rezende and Afonso (2002) find that two important facts have shaped the way Brazilian fiscal federalism currently looks: (a) the transition from authoritarian rule to democracy, following the demise of the military regime in 1985; and (b) the policies adopted in the 1990s to achieve domestic and external balances. Rigolon and Giambiagi (1999) describe the context in which the renegotiation took place and emphasize that it was part of the administrative measures aimed at reducing SNG indebtness.
5. The Collor Plan II attempted to deal with the persistent inflation and increasing difficulty in placing public bonds. The plan aimed to eliminate overnight operations and other forms of price indexation. A Financial Investment Fund was created as a captive market for government securities. Fiscal austerity measures included the blocking of federal spending by the ministries and state companies. Despite lower inflation, political resistance to the economic team doomed the plan (see Gremaud, Vasconcellos, and Toneto 2010).
6. Law No. 7976 of 1989 refinanced the direct and indirect debt of SNGs derived from loans that had been granted by the national government in order to meet commitments due to external credit operations, guaranteed by the National Treasury.
7. RLR is used to calculate the SNG's debt payment limit and the ratio of financial debt to RLR. It is also used as a parameter for the states' fiscal adjustment and restructuring programs. It is calculated as a moving 12-month average of revenue collected, excluding revenue from credit operations, sale of property, voluntary transfers, donations received to meet capital expenses, and, in the case of states, transfers to municipalities, due to legal or constitutional participations.
8. Judicial writs, called *precatórios*, are legal requests for payment of a certain amount by the federal, state, or municipal treasuries. They cannot be appealed. At the end of judicial enforcement, a letter is submitted to the president of the court requiring payment of the debt. The requests received by the court until July 1 of each year are included in the budget proposal, to be paid the following fiscal year. SNGs often have significant amounts of these debts in arrears.
9. The SELIC rate—Brazil's prime interest rate—is the average interest rate charged on daily financing of operations and is backed by government securities registered in the SELIC.
10. According to the Federal Constitution, the Senate is entitled to define amounts and conditions of debt issued by the union, states, and municipalities.
11. The debt negotiations have adopted a "contractual approach." See Grembi and Manoel (2011) for an analysis of Latin America.
12. The IGP-DI is a weighted index of the Wholesale Price Index, the Consumer Price Index, and the National Construction Cost Index, with weights equal to

6, 3, and 1, respectively. The "Domestic Availability" version was created in 1969 with the aim of isolating the effects of coffee price oscillations by assigning a lower weight to export products.

13. The states of Amapá and Tocantins had no significant debt so were not included.
14. Based on Ministry of Finance data.
15. The states of São Paulo and Bahia had already completed their renegotiation.
16. At the end of 1998, the Municipality of Rio de Janeiro presented a proposal for restructuring its debt with the federal government. The proposal suggested the same restructuring terms that applied to the states (Law No. 9496) (see Prefeitura Municipal do Rio de Janeiro 1998).
17. Recently, the Municipality of Rio de Janeiro restructured its debt through a World Bank loan of US$1.045 billion to repay up to 25 percent of the debt renegotiated with the federal government. This prepayment reduced the interest from 9 to 6 percent.
18. See IMF (2003, 9) for a detailed explanation of the crisis. According to the IMF, the Brazilian crisis, like others in emerging markets during the 1990s, would be better "described as capital account crises to distinguish them from the more conventional crises which have their origins mainly in the current account."
19. The Fiscal Responsibility Law was approved on May 4, 2000, as Complementary Law No. 101 (see box 1.3). Passage of a complementary law requires a higher threshold of voting (75 percent of both houses).
20. Leite (2011) argues that some of these factors are key to explaining why the FRL was passed in the Brazilian Congress.
21. Setting up the National Treasury at the Ministry of Finance was a milestone in terms of comprehensive analysis and control of public finance in Brazil. Among other responsibilities, it included (a) executing the budget (cash flow), (b) overseeing subnational public finances, (c) monitoring financial aspects of government banks and SOEs, (d) public debt management (registering, controlling, reporting), (e) managing federal government financial assets, and (f) accounting and reporting on federal government accounts. For several years, the National Treasury was also in charge of "internal control" activities for the federal government.
22. Tavares, Manoel, and Afonso (1999) describe the FRL project and the antecedents of the new fiscal rules.
23. The main sources of information in this section are the Federal Institute of Geography and Statistics (IBGE), the Central Bank of Brazil, the STN, the Council of States Secretaries of Finance of the Ministry of Finance, and the financial statements of several states. Data pertaining to budget execution of the states for 2000–09, made available by the STN based on information provided by the states, were consolidated. Despite differences in methodology and coverage among the different sources, the results obtained for the indicators are consistent, allowing comparison of the data.

24. Central Bank of Brazil data for net public debt and main fiscal indicators distinguish direct and indirect administration (state and municipal governments) from the figures for SOEs. STN data consolidate figures for revenues, expenditures, and gross debt for direct and indirect administration with those related exclusively to dependent companies. Data for municipalities during 2000–09 cover around 95 percent of Brazilian cities.
25. The debt stock is the debt of both state governments and state companies.
26. Data on SNG revenue and expenditures are based on information made available by the STN and by states and municipalities through official sites. Time series presenting the evolution of revenues, shown in figure 1.9, eliminate the impact of inflation.
27. Beginning in 2000, taxes include federal income tax withheld at source and the payment of tax debts in arrears (*dívida ativa*). In 2000, both accounted for 4.5 percent of total tax revenue. Therefore, comparisons can be made for only 2000–09.
28. Reports from the Brazilian Internal Revenue Service (Receita Federal) indicate that the ratio of income tax to GDP was 12.6 percent in 2009, up from 5.5 percent in 2000. The ratio of the IPI to GDP was 1.7 percent in 2006, up from 0.9 percent in 2000, due to a temporary exemption from the IPI granted to the automotive sector.
29. To comply with the targets for primary balance set by the Congress, the federal government may have to reduce the amount of capital grants to SNGs.
30. Investments include the acquisition of financial assets, mostly related to the issuance of bonds of independent state companies.
31. The Financial Fund for Educational Services (FUNDEF) was created by Constitutional Amendment No. 14/96 instituting intergovernmental financial cooperation for improving elementary education. The fund is financed by earmarking percentages of transfers from the revenue-sharing system to guarantee a specified minimum amount of spending per student enrolled in public elementary schools throughout the country. FUNDEF is funded by (a) 15 percent of the municipal and state share of the ICMS; (b) 15 percent of the Municipalities Participation Fund; (c) 15 percent of the FPE; and (d) 15 percent of the municipal and state share in the Compensation Fund for Exports. FUNDEF funds are distributed according to the number of students enrolled in municipal- or state-owned elementary schools. If the money collected from these sources is not enough to guarantee the minimum spending established by law, the federal government is responsible for providing supplementary transfers. In 2007, the earmarking of revenues was expanded, with the creation of the Fund for Maintenance and Development of Basic Education and Teacher Training, to 20 percent from 15 percent, and other revenues were included, mainly state revenues. The distribution criteria were also changed to take into account, among other things, students in higher education, a service provided by the states.

32. In Brazil, federal, state, and municipal officials serve four-year terms. The head of government—the president, the governor, and the mayor—can be reelected once. Federal and state terms coincide, and municipal terms begin and end two years thereafter. Municipal administrations took office in 2001, 2005, and 2009. Federal and state administrations took office in 2003 and 2007.
33. In 2009, the state of São Paulo sold the state bank, Nossa Caixa, to finance investments.
34. Piancastelli and Boueri (2008), after examining the evolution of state fiscal accounts after 10 years of debt renegotation, conclude that the renegotiation was a major effort to improve the fiscal stance of the public sector.
35. Central bank data; http://www.bc.gov.br.
36. See the Ministry of Finance website; http://www.fazenda.gov.br.
37. Data used in this analysis can be found on the STN website and on the websites of several states and municipalities. Information about 2010 municipal finances came from FRL reports, available on the websites of municipalities and the STN. Some indicators may not be available in some years for all the states and municipalities. The Finanças do Brasil (FINBRA) database for states and municipalities is available at http://www.stn.fazenda.gov.br/estados_municipios/index.asp.
38. According to IBGE, the Brazilian territory encompasses five geographic regions: North, Northeast, Center-west, South, and Southeast. The North and Northeast are the poorest, and the South and Southeast are the richest. The nation's capital, Brasília, is in the Center-west Region.
39. States in the sample are Bahia, Ceará, Goiás, Maranhão, Minas Gerais, Paraná, Pernanbuco, Rio de Janeiro, Rio Grande do Sul, and São Paulo.
40. RCL is calculated as current revenue (taxes, intergovernmental transfers, and other) minus constitutional transfers to municipalities (obligatory) minus the revenue of social contributions to the public servants' pension fund.
41. As indicated, the debt stock is subject to monetary correction by the IGP-DI, which varied negatively in 2009 (−1.43 percent).
42. This was the first year of a four-year (2009–12) administration, and, following the political cycle, current expenditures, mainly investments, are reduced, allowing the administration to accumulate cash to spend during the last years of its term.
43. There are other factors influencing SNG fiscal sustainability. These include the intergovernmental fiscal system, the expenditure framework, and taxation reform, which are beyond the scope of this chapter.
44. For example, Article 35 of the FRL prohibits any form of debt renegotiation between public entities. Pellegrini (2012) also analyzes several constraints, such as legal, technical, and fiscal, which impede normal renegotiation of the current debt.
45. Various countries have been moving toward more diversified instruments, including bonds. Total SNG bond issuance in developing countries reached US$45.1 billion during 2000–07 and US$102.8 billion during 2008–10Q1, with

China being the largest and dominant issuer, followed by Russia (Canuto and Liu 2010, based on data from DCM Analytics).

46. Central bank data on domestic debt of the four largest states in 2010 (including direct and indirect administrations) indicate that private institutions provide only 0.5 percent of total funding for domestic debt. They have a notable presence only in Minas Gerais and São Paulo, where they hold about 20 and 10 percent, respectively, of the outstanding SOE debt.

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2

Restructuring of Legacy Debt for Financing Rural Schools in China

Lili Liu and Baoyun Qiao

Introduction

China started to promote nine-year compulsory education in rural areas throughout the country in the mid-1980s. To achieve that goal, the Compulsory Education Law, enacted in 1986, mandated that the central and local governments at all levels guarantee the operational and capital expenditures to implement compulsory education. In practice, the local governments, especially the county-level governments, played a main role in financing rural compulsory education. With limited fiscal resources, local governments financed rural compulsory education funds through a multitude of channels. In particular, to achieve the national goal of accomplishing universal nine-year compulsory education by 2000, local governments (towns and villages) resorted to borrowing to finance school facilitates to help meet the minimum facility standards for all schools, although the borrowing was not allowed by the 1994 Budget Law of China.

In 2000, nine-year compulsory education became universal in China, a historic accomplishment. However, the accumulation of debt that resulted from borrowing to finance rural compulsory education had become a significant fiscal burden on local governments. The aggregate rural education debt was about RMB 110 billion[1] at the end of 2007, about 3.9 percent of aggregate subnational own fiscal revenue, excluding transfers. Of the outstanding compulsory education debt, about RMB 80 billion was used to finance capital expenditure, and about RMB 30 billion was used to finance operational expenditures. The negative impact of rural compulsory education debt on the rural economy and social development had become serious. The rural Tax-for-Fee Reform in 2001[2] was intended to reduce financial burdens (such as taxes, surcharges, and fees) on rural households, but it also further limited local fiscal resources. At the same time, the rural reforms increased the demand for fiscal resources to finance rural infrastructure and social services.

Restructuring the legacy debt for financing rural schools thus became a priority of the central government in the mid-2000s. With the public policy goal in the late 1990s of inclusive economic growth, the debt financing of nine-year compulsory education in rural areas would be replaced by grant financing for all children. It was necessary to resolve the widespread indebtedness of rural local governments to make the debt-to-grant financing transition, and the debt-to-grant financing would need to address the legacy debt and its write-offs.

Resolving the legacy debt and making a transition to grant finance should be viewed as part of building a sustainable fiscal system framework to ensure the delivery of basic public services, including implementation of the Compulsory Education Law. With less fiscal capacity as a result of the rural Tax-for-Fee Reform, the county-level governments could choose new approaches to increase the fiscal burden of rural residents.

China's central government, through the Ministry of Finance, initiated a program of restructuring the rural legacy school debt in 2007. This was a pioneering effort—the first time the central government undertook debt restructuring of subnational governments nationwide. A key design issue in any debt restructuring is how to avoid moral hazard. International experience shows that unconditional write-offs create soft budget constraints. To address the problem of moral hazard, the Ministry of Finance's plan had two distinct features.

First, the fiscal resources to finance the debt write-off were distributed equally among the central government, provincial governments, and subprovincial governments; that is, the central government, provincial governments, and subprovincial governments each contributed one-third of the financial resources.

Second, the distribution of central government grants was based on a formula that took into account the required expenditure to achieve basic provision of education and the local government fiscal capacity to deliver the results. Thus, the distribution of central grants to a particular local jurisdiction was not directly related to the size of the debt of that jurisdiction. This output-based approach was meant to prevent perverse incentives for local governments to increase the size of their debt or to reduce their service of debt in anticipation of more grants or bailouts.

This chapter analyzes the moral hazard aspect of the rural debt restructuring within China's current intergovernmental fiscal framework. The remainder of the chapter is organized as follows. Section two summarizes the compulsory educational system and what responsibilities are assigned to each government level in China. Section three examines the features of rural education legacy debt. Section four focuses on China's strategy to deal with moral hazard. Section five explains how China restructured the legacy debt for financing rural schools. Section six offers conclusions.

The Responsibility and Revenue Assignment for Education in China

China has a unitary system with five levels of government. The central government is at the top under which are four tiers of subnational government: provincial, prefecture (city), county, and township.[3] The central government determines the establishment and the geographic division of the provincial, prefecture, and county governments, and the provincial government determines the establishment and the geographic division of the township governments.

The provincial government, directly under the central government, consists of the governments of the provinces, autonomous regions, and large municipalities with provincial status. A prefecture or a prefecture-level city under the jurisdiction of a province is an administrative division between a province and a county. At the end of 2009, China had 333 prefectures or prefecture-level cities. A county or county-level city is the general administrative division at the local level. At the end of 2009, there were 2,858 counties or county-level cities in China. The township is the basic administrative division in the countryside. At the end of 2009, there were 40,858 townships in China.

According to the Chinese Constitution, the People's Congress and people's government at the levels of province, prefecture (or city), county, and township are the local legislative and executive organs of power, respectively.

Law on Nine-Year Compulsory Education

The Law on Nine-Year Compulsory Education, enacted by the central government on July 1, 1986, mandated requirements and deadlines for attaining universal education (to be tailored to local conditions) and guaranteeing school-age children the right to receive at least nine years of education (six years of primary education and three years of secondary education). People's Congresses at various local levels were, within certain guidelines and according to local conditions, to choose the steps, methods, and deadlines for implementing nine-year compulsory education in accordance with the guidelines formulated by the central authorities. The program sought to bring rural areas, which had four to six years of compulsory schooling, into line with their urban counterparts.

The Decision on the Reform of the Education System by the Central Committee of the Party in 1985 divided jurisdictions into three categories: (a) cities and economically developed areas in coastal provinces and a small number of developed areas in the hinterland (approximately 25 percent of China's population); (b) towns and villages with an average level of development (approximately 50 percent of China's population); and (c) economically backward areas (approximately 25 percent of China's population).

In fact, some jurisdictions in the first category had achieved universal nine-year education by 1985, and all jurisdictions in the category had achieved universal nine-year education by 1990. The jurisdictions in the second category had achieved universal nine-year education by 1995, and technical and higher education were projected to develop at the same rate. The jurisdictions in the third category should attain the basic education target for all students with a timetable consistent with the pace of local economic development, and the central government would support the educational development. The central government also would assist educational development in minority nationality and remote areas.

Currently, there are over 260,000 rural primary and junior secondary schools with about 76 million students (see table 2.1).

Distribution of Educational Responsibilities among Levels of Government

Fiscal decentralization reforms in China after the economic reform started at the beginning of the 1980s provided local governments with significant fiscal autonomy in various areas such as the determination of their own spending priorities and policies on relevant aspects of local budgets.

In 1994, the central government introduced the Tax Sharing System (TSS) reform, with the two major goals of increasing the share of combined government revenue in total gross domestic product and the central share in combined government revenue (World Bank 2002). This reform introduced clear and stable assignments of tax revenues between the central and provincial governments, and created

Table 2.1 Statistics on Rural Junior Secondary and Primary Schools and Students, 2009

Item	Number of schools (unit)	Junior secondary schools	Nine-year primary-secondary schools	Total enrollment (person)
Rural junior secondary education	30,178	22,921	7,257	19,345,061
Run by education departments and collectives	28,590	22,240	6,350	18,498,085
Run by private institutions	1,222	557	665	646,478
Run by other departments	366	124	242	200,498
Rural primary education	234,157			56,555,439
Run by education departments and collectives	231,360			54,941,004
Run by private institutions	2,395			1,260,235
Run by other departments	402			354,200

Source: National Bureau of Statistics 2010.

separate tax administration services at both levels of government. The TSS reform introduced the value-added tax as the major government revenue source, and established a uniform tax-sharing system that provided that the central government would receive 75 percent of the value-added tax and subnational governments 25 percent.

The taxes assigned to the center and the major taxes shared with the subnational governments were collected by the newly created National Tax Services, which operated in all provinces. The new system provided for separate local (subnational) tax services for the collection of the taxes assigned to local governments. The headquarters of the local tax services, the State Administration of Taxation, was empowered to supervise local tax services and prohibit the use of tax exemptions by local governments.

Given the main focus of the TSS reform on the taxation side, however, there was no apparent change in either policy or practice in terms of expenditure assignment between the central government and subnational government and among the four tiers of subprovincial governments. In fact, the TSS restated the prereform expenditure assignment and provided only basic guidelines to define expenditure responsibilities between the central and subnational governments. For example, the State Council Regulations on the Implementation of the TSS in 1994 defined expenditure responsibilities of central and subnational governments as follows:

> Central budgets are mainly responsible for national security, international affairs, the costs of operating the central government, the needs for adjusting the structure of the national economy, coordinating regional development, adjusting and controlling the macro economy, and others. Detail items include: national defense, cost of military police, international affairs and foreign aid, administration costs of the central government, centrally financed capital investments, the technical renovation of central-government-owned enterprises and new product development costs, the expenditure to support agriculture, arts and culture, education and health, price subsidies and others.
>
> Subnational budgets are mainly responsible for the costs of running subnational governments, and the need for local social economic development. Detail items include: the costs of running subnational government, the needs of local economic development, a part of the costs of

> running the military police and militia, locally financed capital investments, the technical renovation of local government-owned enterprises and new product development, the costs of support to agriculture, urban maintenance and construction, and the expenditure to support arts and culture, education and health, price subsidies and others.

These guidelines illustrate that both the central government and subnational governments not only have extensive expenditure responsibilities, but also that these responsibilities overlap and are not specific. Adding to the lack of clarity in expenditure assignments is the fact that the subprovincial governments do not have explicit expenditure assignments. The expenditure assignments for subprovincial governments are basically at the discretion of their provincial governments. To improve expenditure at the subprovincial government level, the Ministry of Finance in December 2002 issued "Suggestions on Improving Subprovincial Fiscal Relations," to provide further guidelines on subprovincial expenditure assignment. However, considerable challenges remain in clarifying expenditure assignment.

Education, for example, is mainly the responsibility of subnational governments. For compulsory education, the role of the central government is that of policy maker and overall planner. In addition, the central government has the responsibility for establishing special education funds for subsidizing compulsory education in poor, minority areas, and teacher education in all areas. The provincial government has the overall responsibility for formulating the development plan for compulsory education and providing assistance to counties to help them meet recurrent education expenditures. The responsibility for actually implementing compulsory education programs lies with the cities or districts of large cities in the case of urban areas, and with counties in the case of rural areas.

The provision of compulsory education services in rural areas is one of the major concerns of the central government because of the generally worse service conditions, especially in poor rural areas. Some initiatives, especially the "Decision on Strengthening Rural Education," issued by the State Council in September 2003, expanded the expenditure responsibilities of the central government on compulsory education. This basic service was defined as a shared responsibility with the goal of supporting students from poor families by waiving their payments for textbooks, tuition, and miscellaneous fees, and by subsidizing housing expenditures for elementary and secondary education students.

In general, several important decision-making powers were decentralized to county governments in implementing the State Council 2003 directive. For example, the county governments were able to close schools or reduce their size in their jurisdictions. This decentralized power eventually influenced the education sector in significant ways. In addition, upper-level governments (the central and provincial governments) became more involved in financing education.

There were two driving forces behind the changes in the assignment of responsibilities for upper-level governments. First, as discussed below, the reduction in revenues that resulted from the Tax-for-Fee Reform rendered some local governments fiscally unable to finance education (Xiang and Yuan 2008), so more transfer funds were required to keep education services running smoothly. Second, reducing disparities in education expenditure was deemed to be a desirable public policy goal. Therefore, more transfer funds should go to poorer areas.

County governments have become the most important—but not the only—players in the current regime of education finance. Other levels of government, such as the prefecture, province, and central government, also have roles to play; even township governments and village self-governing bodies have some responsibilities in particular areas (Huang 2006). The power to make education policy is still centralized in the hands of provincial and central governments. Nevertheless, county governments have been given considerable latitude for making decisions on the daily operations of educational services, as shown in table 2.2.

Revenue Assignment of Rural Compulsory Education

Although there are various financing channels, compulsory education in general is mainly financed by the government, particularly by the government's budgetary expenditure, as shown in table 2.3.

The finance system of compulsory education in China has evolved since the early 1950s, in three major stages.

The first stage was 1950–93. During that period, primary and secondary education services were mainly provided by subprovincial governments. The central government provided financial support, mostly upon

Table 2.2 Assignment of Major Educational Responsibilities among Levels of Government in China

Terms	Central government	Provincial governments	Prefecture governments	County governments
Policy	1. Establishing the educational system 2. Curriculum, approval of textbooks 3. Determining teacher-pupil ratios	1. Making policy for education development 2. Planning for the reorganization of primary and secondary schools 3. Examining and evaluating schools 4. Approving size of teaching staffs	1. Coordinating educational planning 2. Implementating educational examination and evaluation	1. Planning local school system structure 2. Paying teachers 3. Managing principals and teachers 4. Guidancing teaching activities 5. Evaluating rural schools 6. Proposing teacher-pupil ratios
Financing	Transferring funds to help poor and minority areas	Providing support to poor counties	None	Purchasing equipment and books
Teacher salaries	Earmarking transfer funds for teacher salaries	Using transfer funds to support poor counties	Providing transfer funds to poor areas	Paying teachers
Operational costs	None	1. Determining teacher-student ratios and corresponding operational expenditures for rural areas 2. Transferring funds to help poor areas	Helping county governments finance operational costs	Providing funds for operation of schools
Construction costs	Earmarking subsidies for the repair of dangerous classrooms in poor areas	Providing subsidies to county governments to finance school facilities	Helping county government finance building of school facilities	Implementing plans for building schools

Source: Compiled by the authors.

Table 2.3 Financing Sources for Rural Junior Secondary and Primary Schools in China, 2008
RMB millions

Financing sources	Rural junior secondary schools	Percent	Rural primary schools	Percent	Total	Percent
Government	135,722.3	95.03	222,362.4	96.76	358,084.7	96.09
Budgetary	128,372.0	89.88	213,637.4	92.96	342,009.4	91.78
Private school	210.4	0.15	210.7	0.09	421.1	0.11
Donations	823.0	0.58	1,233.2	0.54	2,056.2	0.55
School charge	4,412.2	3.09	4,058.6	1.77	8,470.8	2.27
Tuition	1,173.4	0.82	1,073.3	0.47	2,246.8	0.60
Other	1,656.0	1.16	1,954.2	0.85	3,610.2	0.97
Total	142,823.9	100.00	229,819.1	100.00	372,643.1	100.00

Source: National Bureau of Statistics 2010.

request of the provincial governments. Education services were treated as local public goods, and education expenditure was financed mainly by budgetary funds, education surcharges, donations to education, and student fees. *Minban* teaching staff (nongovernmental employees) were commonly used in rural schools as instructors, and school facilities were financed mostly by local residents.

The second stage was 1994–2003. During that period, the education sector continued to decentralize. The 1994 TSS reform had an important impact on education finance. As noted, the TSS reform had two major goals: increasing the share of combined government revenue in total gross domestic product, and increasing the central share in combined government revenue. Given that larger shares of fiscal resources went to the upper-level governments, especially the central government, and that no changes were made in the assignment of expenditure responsibilities, local governments, especially township governments, began to experience increasing difficulties in providing educational services. During this period, off-budgetary resources, in particular school fees and charges, played a bigger role in financing education than in the first stage.

There were other policy shocks that added to the fiscal pressures facing local governments. For example, during 1996–97, many *Minban* teachers became government employees, in accordance with explicit policies set by the State Council. Local governments were already struggling financially, and the accompanying increases in salary payments added to the burden. In addition, the Nine-Year Compulsory Education plan required all schools in rural areas to comply with regulations concerning school facilities. To comply with these regulations, local governments incurred large increases in construction expenditures.

As shown in table 2.4, with the expanding expenditure per student in rural primary schools in Henan province, salary payments increased significantly, and construction was more concentrated in 1999 to meet the requirement that schools implement the Nine-Year Compulsory Education plan. Meanwhile, a 1999 survey by the Ministry of Finance revealed that the minimum financial gap for the local government to implement the Nine-Year Compulsory Education plan was RMB 35 billion (Hu 2002).

In short, during this period, the increases in expenditures and contracted budgetary revenues rendered some local governments unable to provide enough resources to fulfill their educational responsibilities. Many local governments suffered significant shortages in education funds, with the following consequences: (a) teachers in many provinces could not get paid on time—in fact, the total amount of unpaid teachers' salaries (Beijing, Shanghai, Tianjin, Zhejiang, and Tibet were not included) was RMB 13.6 billion (Liao 2004); (b) students were charged high fees in order to finance the regular operation of schools; and (c) local residents were heavily taxed to finance the new school facilities (see, for example, Li 2006).

Table 2.4 Composition of Educational Expenditures of Rural Primary Schools, Province of Henan, 1999 and 2002
RMB per student

Year	1999	2002	Change
Education expenditure	**364.45**	**545.76**	**181.31**
Teacher salaries	**224.42**	**450.23**	**225.81**
As share of total expenditure	61%	82%	21%
Operational expenditure	**97.16**	**81.59**	**–15.57**
As a share of total expenditure	27%	15%	–12%
Construction expenditure	**42.87**	**13.94**	**–28.93**
As a share of total expenditure	12%	3%	–9%

Source: Henan Education Department 2003.
Note: Bolded text indicates expenditures.

The third stage began in 2003 and continues to the present. To reduce the tremendous financial burdens facing rural households, the central government in 2001 initiated the Tax-for-Fee Reform. The reform canceled various charges and fees levied on rural households by rural local governments, and improved rural tax structure and administration.[4] While reducing the financial burdens on rural households, the reform also eliminated the revenue base for township governments, since their major revenue bases, in particular five agriculture-related taxes and budgetary funds, were no longer available. The central government also reassigned the responsibility for basic education services to the county-level government, and increased the central contribution for financing primary and secondary education.[5]

However, the newly assigned responsibility to the county governments was not accompanied by revenues, since the agriculture-related taxes and other fees were also main sources of the county government budgets. In response to these budgetary constraints, county governments first closed a number of primary and secondary schools, then started to charge higher student fees to finance operational costs for the schools that remained open. Under the new arrangement, teacher salaries were increased and were more likely to be paid on time, while the operational costs were financed jointly by budgetary funds and student fees. The financial arrangements for construction costs, however, remained unsettled (Liao 2004).

The unevenness between revenue availability and expenditure responsibilities since the 1994 TSS reform created serious challenges in service provision at the local level (Jia 2008). Other central government policies also contributed to the financial challenge faced by local governments. In particular, implementation of the Nine-Year Compulsory Education plan required that all rural schools satisfy certain conditions, including good physical facilities and a qualified teaching staff.[6] While this policy led to significant increases in local expenditure needs for education and construction costs, in particular, the central government made no new provision of funds for local governments (Zong 2010).

In response to the imbalances in their public finances, subprovincial governments developed two strategies.

On the expenditure side, both the quality and quantity of some public goods provided by local governments decreased. For example, in some areas, local governments failed to pay teachers on time. In other areas, teachers were perhaps relatively luckier; they could receive their paycheck on time, but with a condition, say, that their salaries would be reduced by 20 percent. Failure to pay teachers was not an isolated occurrence; rather, it reportedly took place across the country, except in some rich areas like Beijing and Shanghai (Zhang 2005).

On the revenue side, it appears to have been difficult for rural local governments to increase revenue collection on their own, since the tax bases and tax rates are largely controlled by the central government. But local governments were able to collect additional funds to finance education and other local public goods through a variety of fees and charges, formally and informally. Given that no horizontal accountability mechanisms were in place, in the face of financial stress it can be reasonably expected that local governments would have increasingly and consistently exerted their powers to obtain money from rural households (Liao 2004).

Serious pressures from this situation redounded to the central government in a variety of ways. To protest unpaid and delayed salaries, teachers first loudly voiced their concerns through their representatives in the People's Congress at different tiers of government. In addition, more teachers quit their jobs in rural schools or moved to schools in richer areas for higher and more stable salaries (Cai 2002; Wang 2004: Zhou, Liu, and Tian 2003). As a consequence, an adverse selection problem for teachers developed across rural schools; those teachers taking jobs at or remaining in rural schools were in many cases not the teachers those schools needed. The loss of qualified teachers reduced the quality of educational services provided in rural areas and raised serious concerns among parents about the quality of education. These concerns eventually filtered up to the central government. In particular, restructuring of legacy debt for financing rural schools needed the immediate attention of the central government.

Fundamentally, county governments assumed the key role in budgeting education finance following the 2003 State Council directive. County governments pool all revenues from own and transferred funds, and decide on their use to finance education and to distribute funds to all schools in all three categories in their jurisdictions. The roles played by upper-level governments are mostly supportive, although in some instances they contribute a significant share to financing general education expenditure. Higher-level governments pay special attention to teacher salaries by earmarking funds, but do little in relation to other categories of expenditures.[7]

Significant Features of Rural Compulsory Education Debt

In general, there is a mismatch between responsibility and revenue assignment in China; in particular, the aggregated own revenue of county and lower governments amounts to only 42 percent of their expenditure, as shown in table 2.5. Although the central government required subnational governments to provide rural compulsory education, the county governments, which are responsible for its implementation, and other tiers of subnational government, had limited resources to do so, which forced them to borrow funds to finance the services (Xiang and Yuan 2008). However, as mentioned, borrowing is not permitted under the Budget Law of China, and this further complicated the debt issue and encouraged county governments to borrow off budget.

The result was that not only was debt concentrated in the county governments, but there was also asymmetric information between the county governments and the upper levels of government, especially the central government, about the size of debt and its service cost. In addition, the debtor-creditor relationship was informal, in general, because the borrowing governments did not have the legal status to borrow (Shi 2004). More important, most county governments were not able to pay the debt by relying on own resources. These factors increased the difficulty of solving the problem of the rural education debt (Wang 2007).

Table 2.5 Own Revenues as a Percentage of Total Expenditures, by Level of Government in China, 2003

Level of government (consolidated)	Average	Minimum	Maximum
Provincial	53	8	75
Prefecture	55	2	85
County and lower	42	0	90

Source: Ministry of Finance.

Table 2.6 presents the share of compulsory debt in subnational budgetary expenditures for 14 provinces at end-2005. Since most of the debt is concentrated in county-level governments,[8] the share of debt in county-level expenditures would be much higher. The debt mainly consisted of arrears on funds owed to construction companies that built the schools and to suppliers, and on funds for teacher wages and pensions. A small part of the debt was incurred by local government off-budget vehicles to construct schools, that is, funds borrowed from financial institutions.

Restructuring the rural compulsory education debt became a priority of the central government in mid-2000. The main reasons include (a) it was an important step toward improving rural human capital and achieving equality between urban and rural education, (b) writing off the rural compulsory debt was the prerequisite to building a sustainable finance system for rural compulsory education, and (c) it was needed

Table 2.6 Compulsory Debt as a Percentage of Subnational Budgetary Expenditure for 14 Regions in China, 2009
RMB billions

Provinces	Compulsory education debt (by end-2005)	Budgetary expenditure	Percent
Inner Mongolia	3.92	192.684	2.03
Jilin	2.31	147.921	1.56
Helongjiang	2.434	187.774	1.30
Jiangsu	5.75	401.736	1.43
Anhui	3.079	214.192	1.44
Fujian	2.312	141.182	1.64
Jiangxi	4.094	156.237	2.62
Hubei	3.074	209.092	1.47
Hunan	4.803	221.044	2.17
Sichuan	9.092	359.072	2.53
Ningxia	0.901	43.236	2.08
Guizhou	3.994	137.227	2.91
Shan'xi	3.065	184.164	1.66
Guansu	2.333	124.628	1.87
Total	51.161	2,720.189	1.88

Source: Ministry of Finance.

to prevent increasing the fiscal burden on rural residents. In addition, writing off rural compulsory education debt was relatively easy in terms of size and complexity, and it could provide experience and knowledge for restructuring other subnational debt (Zhang 2007).

Although the size of the aggregate debt is relatively small, in the view of policy makers, how the debt was restructured would influence the future behavior of subnational governments. In particular, improper incentives could lead to moral hazard for local governments, which could lead to more problems in the future when trying to solve debt problems.

Key Strategy for Dealing with Moral Hazard in Debt Restructuring[9]

The RMB 110 billion rural compulsory education debt accounted for an insignificant portion of the RMB 10.7 trillion in subnational liabilities at the end of 2010.[10] However, the restructuring of the rural education debt represented the first effort to restructure subnational debt; thus, its design and approach would affect subsequent debt restructuring efforts. In particular, an improperly designed framework could create negative incentives for subnational governments concerning their future borrowing decisions.

A key issue in writing off the rural compulsory education debt concerns moral hazard. The soft budget constraint challenge exists in the fiscal system of many countries (see, for example, Liu and Webb 2011). An improperly designed fiscal system encourages moral hazard on the part of local government and creates the soft budget constraint. Not surprisingly, the soft budget constraint issue has also been a challenge for China's fiscal system. To some extent, the compulsory education debt resulted from the soft budget constraint and the weakness of China's intergovernmental fiscal relations.

Consequently, how to deal with a potential moral hazard challenge was a serious concern to policy makers in designing the restructuring package of the compulsory education debt. The restructuring of this debt served as a pilot from which to draw lessons. Finally, restructuring the rural compulsory education debt in China took place within the framework of intergovernmental fiscal relations. The process of the debt restructuring would help clarify intergovernmental fiscal relations in delivering basic education and help inform future reforms to the intergovernmental fiscal system.

There might have been other options to resolve the rural legacy debt. One would have the central government write off the entire debt. This option was not chosen because it would have encouraged moral hazard. Another option would have allowed provincial governments to resolve the debt of their local governments. This option was not chosen because the central government viewed the rural debt restructuring as an opportunity to realign intergovernmental fiscal relations with respect to rural education; letting provincial governments resolve the problem was not feasible given the existing intergovernmental fiscal relations. The chosen mechanism was based on the principles of burden sharing, transparency, and formula-based restructuring. As mentioned, the rural debt is only a small portion of subnational government debt, and there are broader issues concerning moral hazard and opportunistic behavior of subnational governments. The experience of rural debt restructuring can offer lessons on addressing these broader issues.

In restructuring the compulsory education debt, there were two types of moral hazard. The first relates to the overall borrowing size of local governments. As the debtors, the county governments might have an incentive to expand the size of total rural compulsory education debt in anticipation of seeking more central government grants to replace the incurred debt. The second type of moral hazard concerns the behavior of county governments in anticipation of a write-off. Instead of using their own revenues to contribute to the write-off of debt, the county governments might have an incentive to seek more bailout grants to write off the existing debt.

To deal with these two types of moral hazard, the central government designed a strategy with two distinct features.

First, the fiscal resources required for debt write-off and restructuring are distributed among three tiers of government: roughly one-third from the central government, one-third from provincial governments, and one-third from lower-tier governments. Thus, the fiscal burden of debt restructuring is shared.

Second, the distribution of the central grants was based on an output-based rather than an input-based formula. The output includes two set of factors. The first set formed the base on which to calculate the total grants to a jurisdiction, and the second set formed the base to determine the performance of a local government in writing off the rural compulsory education debt.

Regarding the first set of factors, although the overall size of the central government grant was determined by the overall size of the compulsory education debt,[11] the grant going to each individual jurisdiction was not directly linked to the size of the debt of that jurisdiction. The total grants were only a pool that provided the grants' source; the linkage between the pool and its distribution among local governments went through the following two steps.

First, as mentioned, the grants would not be directly related to the total debt of a jurisdiction; that is, the central government grants would not be tied to actual indebtedness of county or town governments.

Second, the distribution of central government grants to local governments for write-offs was determined by a formula that considered four factors within local government jurisdiction: (a) number of students, (b) number of schools, (c) population density, and (d) local fiscal capacity.

By this method, a local government that borrowed excessively would not gain extra advantage, and another local government that borrowed less or paid off its debt would not be in an unfavorable position. By choosing objective factors and giving full consideration to the financial difficulties of all pilot areas, the grants to all pilot areas would be calculated uniformly according to the formula.[12] The areas having more financial difficulty would enjoy a higher proportion of subsidy. Counties and towns that had not incurred debt but needed to cover a certain number of schools and students could obtain funds as a positive incentive. In addition, there was a penalty rule to prohibit new debt for compulsory education. The grants to a local government would be reduced by the central government if new rural compulsory education debt emerged. Provincial government grants were required by the central government to follow the same principles.

The second set of factors formed the base to determine the performance of a local government in writing off the rural compulsory education debt. To encourage subnational government effort in writing off debt, the central government established the incentive by providing a subsidy for those that had made efforts to write off the compulsory education debt, and did not provide a subsidy to those that had not completed the work within the stipulated time limit. That is, central government grants to a province were based on performance, and only after the debt write-offs of lower-level governments could a province receive funds from the central government.[13] The requirements, formula, and matching methods for writing off debt were included to preclude possible rent-seeking behavior.

All pilot provinces and their local governments were encouraged to mobilize revenues to contribute their share for writing off compulsory education debt. Subnational governments were encouraged to raise revenues through, for example, improving collection efficiency of local budgeted revenue, expenditure efficiencies, revitalizing idle school facilities, and mobilizing donations.

Restructuring of Legacy Debt for Financing Rural Schools, in Practice

Based on the above strategy, the central government launched the project to restructure the rural compulsory education debt. In December 2007, the General Office of the State Council transmitted the Advice Notice on Pilots Working on Resolving the Debt for Rural Nine-Year Compulsory Education, which was prepared by the Working Group under the State Council on the comprehensive reform in rural areas.[14] The preparation work included the classification and audit of existing subnational rural school legacy debt.

Implementation of the project followed the existing framework of intergovernmental fiscal relations. Under this framework, rural compulsory education was planned by provincial governments and implemented by their county governments. Thus, the pilot project for writing off rural compulsory debt was organized by provincial governments and implemented by county governments. According to the State Council's Advice Notice, all pilot provinces must have refrained from incurring new debt to finance compulsory education. All subnational governments were required to adjust their financial expenditure structure to establish reliable revenue sources for servicing new debt.

Of the total rural school debt of RMB 110 billion outstanding at the end of 2007, RMB 80 billon had been borrowed to finance capital investments (for school construction). An additional RMB 30 billon was used to finance operational deficits. The implementation strategy was designed to write off RMB 80 billion of debt for financing school construction, with two steps.

The first step was to write off the compulsory education debt of 14 provinces[15] within two years (that is, by the end of 2009). During this step, all non-pilot-project provinces would choose two or three counties (cities, districts) to pilot the writing off of such debt. After progress was achieved in the 14 provinces and the pilot cities and counties, the second step was to extend the restructuring exercise to all other provinces, and to complete the write-off of the debt in all non-pilot provinces by the end of 2010.

While the originally planned central government contribution toward writing off the RMB 80 billion compulsory education debt had been projected to be RMB 26.67 billion, the final central government contribution was RMB 30 billion, slightly higher than the originally planned one-third, and the subnational government contribution was RMB 50 billion. By the end of 2009, the central government provided RMB 14.5 billion in grants, about 90 percent of the total funds, for writing off the debt of 14 pilot provinces and Chongqing, consistent with the schedule of debt write-off.

In 2009, the central government launched a project of compulsory debt write-off in non-pilot areas. By the end of 2009, RMB 3.58 billion in grants had been provided to the non-pilot provinces, and in 2010, the remaining RMB 11 billion in grants was transferred to a central government account for distribution to the non-pilot provinces. By the end of 2011, the funds were almost completely disbursed.

Given the success of writing off rural compulsory education debt relating to capital financing in the pilot areas, the central government in 2009 initiated a new program to write off debt that was used to finance operational deficits in the pilot areas. The same output-based formula was used. The total pool of the central grants for writing off operational debt for compulsory education was 37.5 percent of total operational debt related to rural compulsory education, the same percentage as that for the capital debt.

The first 14 pilot provinces completed the task of writing off debt in 2009, which benefited about 1.7 million rural creditors. The 17 non-pilot provinces actively prepared for the write-off and started writing off debt in 2009. By the end of 2009, 31 provincial governments had paid RMB 56.6 billion of the rural compulsory education debt, among which the central government provided RMB 14.5 billion in grants, and subnational governments, including provincial governments, financed RMB 42.1 billion. By the end of 2011, almost all rural compulsory education debt had been restructured, including a RMB 30 billion operational deficit. Since 2007, the central government has contributed RMB 30 billion toward writing off rural compulsory education debt, or 37.5 percent of the debt.

To ensure implementation of the overall strategy, the central government has established a management system to supervise implementation. In principle, all central government grants were designed to contribute to the write-off of the compulsory education debt. Meanwhile, for an individual local government, the remaining grants from the central government after writing off compulsory education debt could be arranged to write off other local non-education-related debt, with priority given to the rural-education-related debt.

Subnational governments are required to establish a *compulsory education debt control system* to monitor grants from the provincial and central governments and the progress of writing off debt to make sure the grants are used effectively and follow central government requirements. In addition, the departments of finance of provincial, municipal, and county governments are required to report the use of the grants in their budget and final financial reports to the relevant People's Congress or Standing Committee. The provincial finance department must report the progress of the write-off of compulsory education debt and the usage of grants to the central government on a monthly base. The penalty may be imposed rule if new debt were contracted. In addition, the Ministry of Finance retained RMB 2 billion to deal with contingencies.

It is too early to assess the impact of writing off the rural education debt, since the entire exercise was completed only at the end 2011. Several questions will necessarily arise, including: Do local governments continue to borrow to finance rural education? Given the transition from debt to grant financing of rural compulsory education, has the grant allocation system been sufficient to finance compulsory education?

Although China achieved universal compulsory education in 2007, a key question is how to ensure the sustainability and quality of education. Evaluating the debt write-off and addressing these questions will need to be done in the context of the evolving changes in the intergovernmental fiscal system. Chinese reform of its intergovernmental fiscal system is ongoing, as are major discussions on the assignment of expenditure functions among the tiers of governments; the streamlining of the tiers, potentially into three tiers; and the need to continue to reform the intergovernmental revenue system to grant subnational governments revenue flexibility at the margin, which is critical to underpin their access to financial markets.

Conclusion

International experience has shown that it is difficult to undertake debt restructuring and to write off debt liabilities while managing moral hazard. In a unitary system of government, the design mechanism by the central government has an important bearing on the incentive signals to subnational governments and financial markets. Important lessons can be drawn from China's experience of formulating its strategy and framework for dealing with the write-off of rural compulsory education debt.

It is important to have proper intergovernmental fiscal relations to assure the delivery of basic public services. Besides the proper assignment of expenditure and revenue among the tiers of government, it is necessary to provide formal fiscal instruments for subnational governments to manage capital expenditure. One of the main reasons for the existence of China's subnational government compulsory education debt was the lack of fiscal resources and fiscal instruments, such as formal debt financing.

A suitable subnational debt management framework is a critical part of intergovernmental fiscal relations. In designing a sound subnational debt management system, it is important to have an information system and an accounting and statistics reporting system to ensure the risks of subnational debt are transparent and reported. In addition, there needs to be a functioning audit department. More important, subnational governments in general have the incentive to overborrow because of the soft budget constraints and the common pool problem. Thus, it is important to provide proper incentives to avoid moral hazard.

Writing off subnational debt should proceed with the goal of improving intergovernmental fiscal relations. In China, county governments should be responsible for servicing their debt, which was consistent with the responsibility assignment of the existing fiscal system. However, the county governments may lack incentives to pay their debt without the effective incentive provided by the central government. Although the central government has sufficient fiscal resources to write off the entire rural education debt, such a write off would lead to moral hazard problems.

China established a system in which the distribution of grants was based on a transparent, rule-based, and output-based formula; the distribution of the grants to a particular local government was not related to the size of the debt of that local government. If a grant to an individual jurisdiction were linked to the size of its debt, it could undermine efforts by that local government to prudently manage its debt service, and at the same time could encourage accumulation of additional debt in anticipation of larger bailouts. The system, based on the performance efforts and standard factors of local governments, such as the size of the student population and their respective fiscal capacity, encouraged local governments to achieve the goal while managing moral hazard problems.

Each debt restructuring will need to examine the origin of the debt problem and the specific historical and institutional context of the legacy debt. Any debt restructuring will need to pay close attention to the design and its incentive effects.

The experience and lessons learned from China's rural debt restructuring can help generate lessons for developing a consistent strategy for debt restructuring in general. A rule-based debt restructuring reduces ad-hoc bargaining and adverse incentives, a hard budget constraint prevents moral hazard, and burden sharing provides proper incentives and avoids free-riding behavior, while also recognizing the incentive role played by higher levels of government to leverage reform.

Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

1. The exchange rate at the time of writing of the RMB (renminbi) to the U.S. dollar was US$1 to RMB 6.30. The RMB has appreciated continuously since 2005, at about 3–5 percent per year.
2. In 2001, a package of policies called the Tax-for-Fee Reform was enacted. See the next section for details.
3. Based on Article 30 of the Constitution of China of 2004, the administrative division of China is as follows: (a) the country is divided into provinces, autonomous regions, and municipalities directly under the central government; (b) provinces and autonomous regions are divided into autonomous prefectures, counties, autonomous counties, and cities; and (c) counties and autonomous counties are divided into townships, nationality townships, and towns. Municipalities directly under the central government and other large cities are divided into districts and counties. Autonomous prefectures are divided into counties, autonomous counties, and cities.
4. The reform started with a pilot program in Anhui province and later was implemented nationwide. Before the reform, there were five agriculture-related taxes, including various taxes on agriculture and a slaughter tax, and various charges such as an education surcharge. There were three core components of the 2001 Tax-for-Fee Reform: (a) cancelations of charges and fees imposed on rural households, including the cancelation of township general fees, the educational surcharge, and the slaughter tax; (b) two adjustments: (i) changes in the agriculture tax made the amount of taxable land and the tax rate fixed, and the production level should be determined by the average of the past five years; the maximum tax rate was set at 7 percent; and (ii) changes in the special agriculture tax. This tax is levied by the procedure applied to the agriculture tax but with a higher tax rate; and (c) one reform: the revenue the village can collect is essentially a surcharge on the agriculture tax, the maximum rate of which is 20 percent. This surcharge can be used to pay for three items in village expenditures: (i) salaries of the leaders in the village self-governing committee, (ii) the old-age support program, and (iii) the operational costs of the governing body. After this reform, only the agriculture tax remained. In 2006, the agriculture tax was also abolished.
5. In 2001, the State Council issued a new policy, the "Decision on the Reform and Development of Primary Education," which assigned the responsibility of providing educational services to county governments. In May 2002, the State Council issued a complementary policy change for education. In the "Notice on Improvement of Administration of Compulsory Education in Rural Areas," the

responsibility for financing compulsory education was removed from township to county governments. The two regulations ended the township-centered system of the previous 17 years (1985–2002), and the county governments began to play a core role in providing educational services.

6. In 1993, the central government issued a Blueprint on Education Reform and Development, which stated that "two basics" should be reached before 2000. In the following years, the Ministry of Education issued several regulations on the qualifications of teachers and the status of school facilities. To meet the requirements, township governments, administrative villages, and households made a big effort, but sizable debt was accumulated, since outlay expenditures were beyond the ability of local communities.
7. For example, 1,424 counties out of a total of 2,806 received earmarked transfer funds for teacher salaries in 2003.
8. Following implementation of the State Council Directive in 2003, township and village government debt was transferred to the accounts of their respective county governments.
9. This and subsequent sections are based on discussions with Ministry of Finance officials.
10. "Auditing Report 2010," No. 35, National Audit Office of China.
11. The deadline for calculating the size of debt was December 31, 2005.
12. The grants for writing off the compulsory education debt for pilot areas were based on a standard compulsory education input gap (standard compulsory education debt) and the coefficient of grants. The formula was: Grants for a particular pilot area = the standard input gap (of the area) × the coefficient of grants (of the area), where the standard input gap (of the area) = ∑[(0.85 × the number of students in rural compulsory education [county-level jurisdiction where the rural population stands for no less 60 percent of total population] × the standard input gap per student) + (0.15 × the number of the schools × the standard input gap per school × the unit cost difference)]. The standard input gap per student and the standard input gap per school are calculated, respectively, in accordance with the number of students and population density by provincial jurisdictions based on the overall input gap. The unit cost difference is calculated by county based on the factors related to construction cost, such as the geographic elevation and weather conditions. The coefficient of grants is determined by fiscal capacity. The coefficient grants for the middle and western regions follow the coefficient of fiscal difficulty applied in the general transfers.
13. The annual grants for a pilot area were based on the schedule of writing off compulsory education debt for that area and used the following formula: The amount of grants (in year T) = the amount of debt that had been written off (in year T) / the total amount of the compulsory education debt that should be written off × the total grants for the particular pilot area. The grants were partially advanced at the beginning of the year based on the anticipated write-off during the year, and the remaining portion was given at the end of every year

after completion on schedule. The funds provided by the central and subnational governments earmarked for writing off the debt were managed in the single account system of the National Treasury and monitored regularly.

14. The General Office of the State Council, 2007, No.70.
15. The 14 provincial jurisdictions were Anhui, Fujian, Guansu, Helongjiang, Hubei, Huizhou, Hunan, Inner Mongolia, Jiangsu, Jiangxi, Jilin, Ningxia, Shan'xi, and Sichuan.

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3

Managing State Debt and Ensuring Solvency: The Indian Experience

C. Rangarajan and Abha Prasad

Introduction

There has not been any repayment default among the Indian states,[1] although fiscal stress and debt repayment pressures were experienced by many states in the late 1990s with continued deterioration evidenced in the early 2000s. The deterioration in the current account was the driving force for declining fiscal health as reflected by the worsening of fiscal and primary balances. An analysis of the evolution of states' debt, deficit, and interest payments reveals three distinct phases.

The first, pre-1998 phase, was characterized by low current account (revenue balance)[2] and fiscal deficits, with moderate debt levels. The second phase, during the late 1990s to mid-2000s, reflected significant deterioration in all key deficit indicators, with rising debt levels and interest burden. During this period, the outstanding states' debt to gross domestic product (GDP) peaked at 32.8 percent in 2003–04, up from 20 percent in 1997–98, and interest payments as a share of revenue receipts increased from 16.9 to 26 percent over the same period.

Of concern was the fiscal stress experienced by the central government over the same period (Pinto and Zahir 2004), during which the combined center-state fiscal deficit rose from 7.3 percent of GDP to

9.4 percent. Furthermore, this reflected only the direct liabilities of states; exacerbating the debt burden and repayment pressure were the contingent liabilities, in the form of guarantees issued by states to support their enterprises. This was followed by the third phase and the onset of fiscal correction and reforms from the mid-2000s onward. This is reflected in the lowering of all key deficit indicators and debt and interest payments as a share of GDP.

The resulting reform package had three interrelated components. First, to reverse the fiscal decline, a fiscal adjustment package was formulated to control the growth of current expenditures (such as wages and pension), and structural reform of the taxation system (such as moving from a turnover tax to a value-added tax) was instituted. Second, a rule-based institutional framework was developed to ensure the sustainability of the adjustment and consolidation. Third, there was a move from central government onlending to states toward market-based financing, with a focus on both self-regulation (through fiscal legislation) and market discipline.

The priority of fiscal consolidation was to restore the balance of revenue accounts, that is, to reduce the revenue deficit to zero. It was realized that even after lowering the primary deficit, the debt service repayment pressure and high indebtedness would continue, because about 80 percent of states' borrowings during 2003–04 was at high-cost, non-market rates. But turning states to a sustainable fiscal path implied reducing both the stock of debt and the cost of borrowing. However, debt restructuring, write-offs, and relief would have an inherent moral hazard challenge. Being cognizant of this, the debt restructuring program was linked with broader institutional reforms, including providing incentives for states to undertake difficult fiscal reforms.

The Twelfth and Thirteenth Finance Commissions (FCs)[3] comprehensively examined the situation for both the center and the states, highlighted their interdependence, and presented an overall strategy. Most subsequent reforms in terms of fiscal responsibility legislation (FRL) were based on a well-considered strategy and incentive structure. Although the steps taken were gradual, the synergistic effect of many institutional, fiscal, and legislative reforms was much greater. The reform efforts were initiated and implemented by different parts of the government—the FC, the Ministry of Finance (central government), the states themselves, the Planning Commission, and the Reserve Bank of India (RBI). All parties were aware that this was not "business as usual" (World Bank 2005), and there was a sense of urgency about transforming the situation.

Among the states themselves, there was a move away from competitive populism (Kurien 1999), which included subsidies and lowering tariffs, toward coordination by ending the competitive tax rate reduction and instituting the value-added tax, which proved to be highly buoyant. This, coupled with increases in the states' share of central taxes instituted by the Twelfth and Thirteenth FCs and the high buoyancy of the center's direct taxes, improved state finances and led to their progress towards the FRL goals. The coordination and consultation among all engaged entities ensured consistency of approach and moved the reforms forward.

There is ample fiscal literature on the states' fiscal reform—fiscal rules, the quality of fiscal adjustment, expenditure and taxation reforms, power sector reform, and budget and financial management reforms.[4] This chapter focuses on the states' borrowing and debt restructuring process, underpinned by the move toward a rule-based framework and market discipline.[5] It concentrates on the perspective of the policy maker during this period and reflects on the key challenge that was to balance the provisions of debt relief with the need to avoid moral hazard and enforce fiscal discipline.

The rest of the chapter is organized as follows. Section two presents the states' borrowing framework as prescribed by the constitution, and changes in the borrowing channels and lending policy for states, while incentivizing market access with a rule-based system. Section three summarizes the trends in states' deficits, debts, and interest payments in the last two decades, and highlights interstate disparities in fiscal performance. Section four presents the major policy and institutional reforms undertaken to restructure states' debt and discusses efforts to minimize moral hazard. Section five presents the impact and challenges of the ongoing global financial crisis. Section six offers conclusions.

States' Borrowing Regime

India is a federal polity of 28 state governments and 7 union territories. The states' borrowing regime is defined by federalism, characterized through the constitutional division of powers among the three levels of government—the center, the states, and the local bodies.[6] The power to raise major taxes is allocated to the central government, while major expenditure responsibilities are assigned to states due to their proximity to local issues and needs. While states' own revenues constitute 37 percent of total revenue receipts, their expenditures account for 55 percent of total central government expenditure (RBI 2011a). The imbalance is addressed through fiscal transfers from the center to the states, mandated by the FC.

The constitutional arrangements for revenue sharing among the Indian federation and the consultative mechanism among the center and states have tended to reduce the risk of explicit state defaults.[7] Regarding the constitutional arrangement, the FC uses a formula-based approach to allocate taxes and grants, with the objective of filling the expenditure-revenue gap (deficit financing). The vertical sharing between the center and states is simplified by including all central taxes and excise duties in the divisible pool of central taxes.[8] For the horizontal sharing among states, the FCs have attempted to correct the differentials in revenue capacity and cost factors inherent in the diversity of states. The pattern of transfers through the FC channel shows that the share in central taxes has persistently been the predominant component of revenue sharing since the First FC (RBI 2011a). Starting with the Ninth FC, a greater emphasis on fiscal discipline has been added to balance the gap-filling approach (RBI 2007).[9]

Residual imbalances in the fiscal accounts after the federal transfers are financed through borrowing. The main borrowing sources are domestic, external, and issuance of loan guarantees. The borrowing channels are multiple and the process complex but are organized around the principles of maintaining sustainability, solvency, and liquidity of the states (for a description, see box 3.1).[10] The overall control is with the center, under Article 293(3) of the Constitution, which states that if any state government is indebted to the center, it requires the center's permission to borrow. Further, the Constitution forbids states from borrowing abroad on their own. Thus, all external borrowing must be onlent or guaranteed by the center.[11]

The limit on the annual amount and sources of borrowing is based on consultations among the center, the state government, the Planning Commission, and the RBI.[12] Previously, after the delinking of plan[13]

Box 3.1 State Borrowings

Borrowing channels for states are multiple and the process complex; some channels are controlled and restricted by the center and others are more autonomous.

Borrowing channels controlled by the center are the following:

- *Market borrowings.* Market borrowings are controlled by the center and managed by the RBI.[a] The state securities issued through this channel are eligible for meeting the banks' statutory liquidity requirements and are thus backed by "automatic" intercepts from the state treasury account (automatic debit). There have been no restructuring or defaults associated with these, and investors perceive an implicit sovereign guarantee attached to them.
- *Loans from the center.* Historically, the center used to borrow and onlend to states. This has now changed, with financial market developments and states' ability to borrow on their own behalf, onlending from the center was discontinued in May 2005.
- *Loans from banks and financial institutions.* The center sets the global ceiling on the amount states can borrow from the banks and financial institutions, but the rate of interest is negotiated directly by the state with the concerned creditor. The rate of interest depends on the perceived credibility and fiscal position of the state.
- *External loans.* Previously, the center would onlend the proceeds in rupees at harder terms, adjusting exchange exposure and elongating maturities. With the recent change in lending policy, the entire loan proceeds are passed through directly by the center to states at the same terms (currency, maturity, and amortization) given by the creditor. The states bear the currency and the refinancing risk, but most do not undertake an impact evaluation of the cost-risk trade-offs of such transactions on their total debt portfolios (see table B3.1.1).

Table B3.1.1 Sources and Features Attached to State Borrowings

	Amount controlled by the center	Automatic intercepts	Creditor perceives guarantee
External loans	Yes	Yes	Yes
Loans from center	Yes	Yes	—
Market borrowings	Yes	Yes	Yes
Loans from bank and financial institutions	Yes	No	Partially
Provident funds	No	No	No
NSSF	No	No	No
Contingent liabilities	No	No	Partially

Note: NSSF = National Small Savings Fund. — = not applicable.

Borrowing channels not controlled by the center are the following:

- *Small savings loans and use of state provident funds.*[b] Prior permission from the center is not required for these. The small savings schemes are run by the center with a social security objective to encourage household savings. Eighty percent of the collections within a state's territory are automatically passed on by the National Small Savings Fund to that state. The rate of interest

(continued next page)

Box 3.1 (continued)

paid by states is currently fixed at 9.5 percent. The money is available for 25 years with a five-year grace period.

- *Special purpose vehicles.* States issue loan guarantees to special purpose vehicles, which borrow in the market with the backing of these guarantees. Anecdotal evidence suggests that loan proceeds have been sometimes used to finance current state expenditures.

Liquidity management:

- *Ways and means advances (WMA) from the RBI.* These are designed to meet temporary liquidity shortfalls. They are formula based and depend on the state's total expenditures. If the shortfall is higher than the WMA amount, the state gets into overdraft, which is extended at a penal rate of interest to be cleared within 10 days or the account of the state is frozen. If there is surplus cash in the single treasury account, it is invested in 14-day intermediate treasury bills.

In the interest of transparency, the number of days a state uses the facility during a fiscal year is published in the RBI's Annual Report. Access to this short-term credit facility disciplines states to manage liquidity shortfalls prudently to avoid closure of accounts, and benefits them in avoiding arrears and payment defaults.

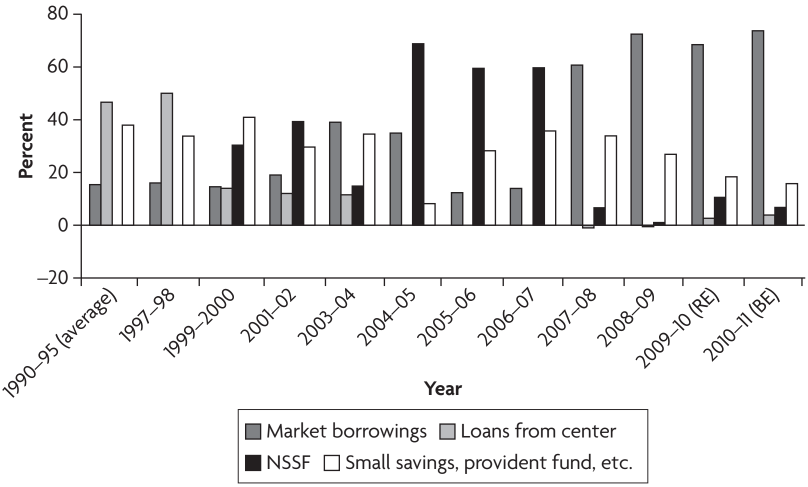
a. The RBI manages domestic borrowings for each of the 28 states through separate agreements with each.

b. A provident fund is a retirement benefit scheme; employees contribute 12 percent of monthly wages and can withdraw funds on retirement or on reaching age 55. Contributions are an unfunded liability in the public account, but balances are available to the state (see Rao, Prasad, and Gupta 2001).

borrowing and plan grants, states tended to revise their objective of maximizing plan assistance by arguing for higher plan sizes, thereby committing to higher borrowing. This changed considerably with the enactment of FRL targets. Key decision parameters on the demand side include the states' financing needs, developmental needs, repayment profile, and, since the early 2000s, its debt sustainability. On the supply side, an important factor is the absorption of liquidity from the market by both the center and states, without impinging on the supply of credit for the private sector for productive purposes.[14] Since the mid-2000s, the ceiling on borrowing by a state has been capped by the fiscal targets under the state-level FRLs.[15]

Figure 3.1 illustrates the changing financing pattern of states' debt during the 1990s and 2000s. This mirrors three phases, with a decline in the center's loan intermediation and onlending (since 1998–99), an increase in the National Small Savings Fund (NSSF)[16] and small savings borrowings (1999–2000), and the move toward market-based financing since mid-2000.

Figure 3.1 Composition of Financing Pattern of State Deficits (as of End-March)



Source: Reserve Bank of India.
Note: BE = budget estimates, RE = revised estimates, NSSF = National Small Savings Fund (described in box 3.1).

Traditionally, loans from the center were the dominant source of funding for states. In keeping with the trend of financial sector liberalization, the center's loan intermediation role has been reduced since 1999–2000. The other notable change has been the rising share of NSSF and small saving loans (see box 3.1 for a description). The share of NSSF increased sharply to 69 percent during 2004–05 from 39 percent during 2001–02. This characterized a move from center-controlled borrowings to the autonomous NSSF but at higher cost (NSSF loans at 9.5 percent compared with cheaper market loans, weighted average of 8.39 percent during 2010–11). There is an inflexibility related with NSSF borrowings, since these are based more on availability and collection within the territory of the state than the requirement by the state to borrow. The NSSF loans are also at higher interest costs and have been more asymmetrically beneficial for the center (Thirteenth FC, 144).

Given the Twelfth FC recommendations for greater autonomy and discontinuation of the financial intermediary role for the center, the lending policy was changed, with more market access for states.[17] Thus, states got more freedom, but also greater responsibility to manage their debt. A consequence of the new lending policy was the move to market discipline and transparency to enhance credibility among the market participants. Competition gradually increased among states to avail themselves of the best market terms and obtain credit ratings. There has been evidence of some variation in the spreads among states, with some states borrowing at slightly lower rates, although the overall range of the spreads has been narrow (table 3.1).

Cross-country evidence shows that spreads over central government securities should be linked to debt and deficit (fiscal) indicators of states. For example,[18] Schuknecht, von Hagen, and Wolswijk (2009) concluded this for the European Union member states, and Lemmen (1999) analyzed similar issues for the subnational governments in Australia, Canada, and Germany. Poterba and Rueben (1999) found that states with tighter antideficit rules and authority of state legislatures can issue debt at a lower interest burden. However, somewhat counterintuitive is the case in India. Bose, Jain, and Lakshmanan (2011) indicate that the conventional deficit indicators have not been significant in determining the yield spreads during 2006–07 to 2010–11. The study, however, concludes that since the period is characterized by the prevalence of rule-based fiscal policy, it appears to have provided confidence to investors regarding states' commitment to fiscal discipline. Although the impact of FRLs cannot be directly determined, it cannot be undermined.

Table 3.1 Weighted Average Spreads during 2010–11

Weighted average spread[b] (basis points)	General category states/ union territories	Special category states[a]
30–40	Puducherry, Gujarat, Goa, Rajasthan, Tamil Nadu, Bihar	Manipur, Nagaland, Meghalaya, Tripura
40–50	Kerala, Andhra Pradesh, Madhya Pradesh, Punjab, West Bengal, Uttar Pradesh, Karnataka, Haryana, Orissa	Assam, Himachal Pradesh, Jammu and Kashmir
50–60		Sikkim, Uttarakhand

Source: Rakshitra, various issues, The Clearing Corporation of India Ltd.

a. Special category states are all the North-eastern states, along with Jammu and Kashmir, Himachal Pradesh, and Uttarakhand. They have distinct characteristics: a low resource base, cost disabilities due to their physical geography, sparse terrain, remoteness, and historical circumstances. These states account for only 5–6 percent of all states' gross domestic product.

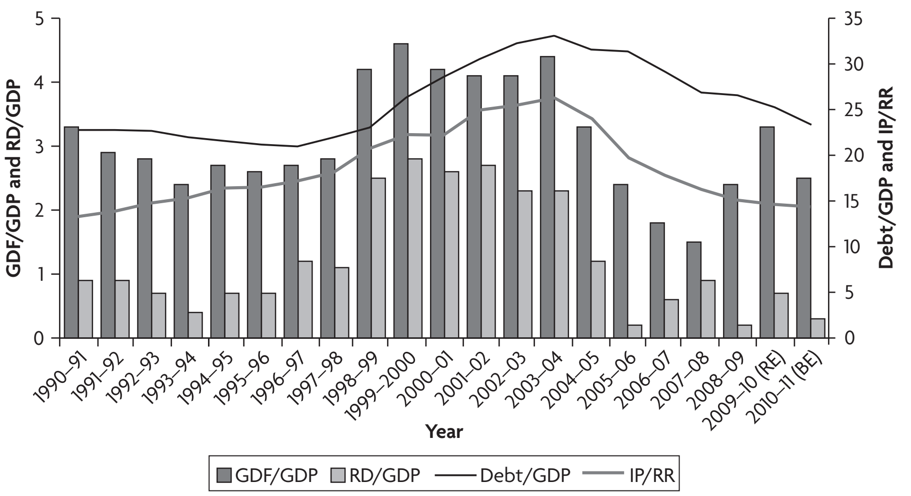
b. Over the center's benchmark.

This shifting in the sources and methods of state borrowing has had a bearing on the interest payments, deficits, and debts of the states. The next section presents the changing trends of states' fiscal deficit, debt composition, and the interest burden, and details on interstate variability in these key indicators.

Trends and Composition of States' Deficit, Debt, and Interest Burden

An analysis of the evolution of states' deficit, debt, and interest burden (defined as the ratio of interest payments to current receipts) during the 1990s and 2000s reveals three distinct phases (as depicted in figure 3.2). The first phase, in the early to mid-1990s, was characterized by low current account and fiscal deficits, moderate debt levels, and a tolerable interest burden. The second phase, during the late-1990s to mid-2000s, was characterized by a significant deterioration in state finances, with all key deficit indicators, debt levels, and interest burden rising. The third phase, from the mid-2000s, was

Figure 3.2 Deficit and Debt as Share of GDP and Interest Payments as Share of Revenues



Source: RBI Handbook of Statistics on State Finances, various issues.

Note: BE = budget estimates, GDP = gross domestic product, GFD = gross fiscal deficit, IP = interest payments, RD = research and development, RE = revised estimates, RR = revenue receipts.

characterized by the onset of fiscal correction and reforms and manifests with improvements in key fiscal indicators.

Until the mid-1990s, states' finances were relatively stable, characterized by low current and fiscal deficits, averaging below 1 and 3 percent of GDP. Debt levels remained moderate at about 20 percent of GDP, and the interest burden hovered close to 15 percent of revenue. The turning point came during 1998–99, with a significant deterioration in the current account, which became a key driving force for the declining fiscal health of the states, with increased spending on administrative services and interest payments.

The next phase, 1998–99 to 2003–04, saw the steep rise in the fiscal deficit as a ratio of GDP—from 2.8 to 4.2 percent; the revenue deficit more than doubled from 1.1 percent of GDP to 2.5 percent. As a result, the states' outstanding debt to GDP grew from 21.7 percent during 1997–98 to its peak of 32.8 percent during 2003–04. Interest payments as a share of revenue receipts (repayment burden) rose from 17.9 to 26 percent over the same period, and the primary deficit grew from 0.9 to 1.5 percent. This period, until 2003, was also characterized by higher interest rates, with the interest rates being gradually liberalized; the average market interest rate on states' borrowing was over 10 percent during this period. Concomitantly, the average interest burden, at 23.4 percent, was significantly higher than the 15 percent considered tolerable for a sustainable debt level (Dholakia, Mohan, and Karan 2004).[19]

There is vast fiscal literature on the factors leading to the deterioration of state finances in the late 1990s. Factors considered critical to the fiscal deterioration include the impact of the wage revisions; inability to contain wasteful expenditure, including subsidies; reluctance to raise additional resources; and competitive reduction in taxes. Mohan (2000) pointed to the increasing debt service payments and inadequate returns on government spending as important factors behind the deterioration in states' fiscal conditions. Acharya (2001) and Rao (2002) attributed the worsening of revenue (current) balance during this period to the implementation of the Fifth Pay Commission recommendations.[20] The RBI Study of State Budgets, 2002–03, while drawing attention to the growing fiscal and revenue deficit and high debt levels of states, pointed to the following causes of the deterioration in states' fiscal condition: (a) an inadequate increase in tax receipts, (b) negative or negligible returns from public investments due to losses in public sector undertakings (PSUs), (c) large subsidy payments, (d) increased expenditure on salaries due to pay revisions, and (e) higher pension outgo. Another study, by Prasad, Goyal, and Prakash (2004), concludes that interest payments played a prominent role in the deterioration of state finances.

Until the mid-1980s, interest rates on government borrowing were highly subsidized, indicative of the degree of financial repression. After the 1980s, the rates on government bonds became progressively aligned with market interest rates; during the 1990s there were increases in both bank deposit rates and policy rates (table 3.2). During the 1990s, average interest rates rose, and those on state government bonds averaged

Table 3.2 Deposit Rate of Major Banks for Term Deposits of More Than One-Year Maturity
percent

Year	Average interest rate	Bank rate/repo rate/reverse repo
1	2.0	3.0
Mar-91	10.0	10.0
Mar-92	12.5	12.0
Mar-93	11.0	12.0
Mar-94	10.0	12.0
Mar-95	11.0	12.0
Mar-96	12.5	12.0
Mar-97	12.0	12.0
Mar-98	11.3	10.5
Mar-99	10.3	8.0
Mar-00	9.5	8.0
Mar-01	9.3	7.0
Mar-02	8.0	6.5
Mar-03	5.3	5.0
Mar-04	4.8	4.5
Mar-05	5.8	4.75
Mar-06	6.5	5.5
Mar-07	8.3	6.0

(continued next page)

Table 3.2 (continued)

Year	Average interest rate	Bank rate/repo rate/reverse repo
Mar-08	8.3	6.0
Mar-09	8.3	5.0
Mar-10	6.8	5.0
Mar-11	8.6	6.75

Source: RBI 2011c.

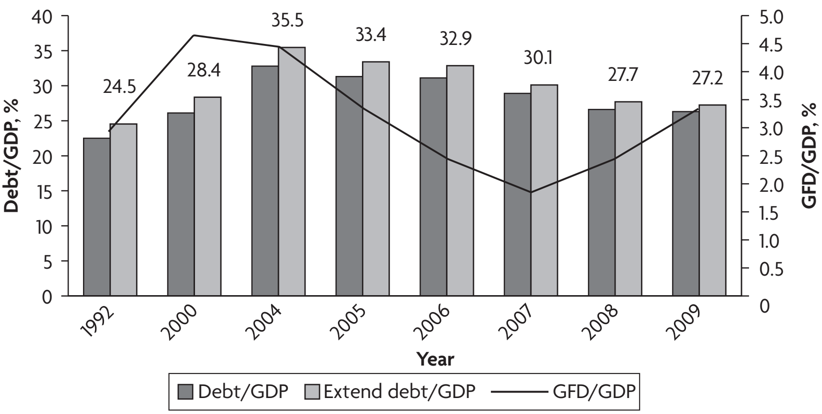
Note: Average interest rate refers to the midpoint of interest rates charged by commercial banks on demand deposits. In column 3, the policy rate used is the relevant policy rate at that time. The bank rate was used for the period prior to 2003, when it was in active use. For the subsequent period, the repo/reverse repo rate was used depending on the prevailing liquidity conditions in the system.

over 10 percent during the 1990s (RBI). At the same time, the reliance on market borrowing to finance the fiscal deficits increased from 11 percent in the 1980s to 16 percent in the 1990s. Significant changes in the structure and cost of state government debt contributed to a sharp increase of about 60 percent in the repayment burden from the beginning to the end of the 1990s. Interest rates started softening in the mid-2000s, and these were taken advantage of in formulating the debt swap scheme for states (discussed in "Debt Restructuring and Institutional Reform" section).

The data in figure 3.2 capture only the direct and explicit state liabilities; exacerbating the debt burden and repayment pressure were the contingent liabilities, in the form of guarantees issued by states to support their enterprises. During the mid-to-late 1990s, there was a rapid increase in the issuance of guarantees by states to support their public enterprises, many of which could not borrow on their own credit strength.[21] Although the latest data indicate that loan guarantees issued by states were lower at 2.8 percent of GDP by end-March 2009 compared to 3.3 percent of GDP in 2008, this does not incorporate the unfunded pension liabilities or the losses of the state PSUs. The Thirteenth FC estimated that by the end of 2007–08, about 1,160 state PSUs had accumulated losses of about Rs 659.24 billion (almost 1.3 percent of GDP), particularly the implicit liabilities associated with power utility companies, because their large accumulated losses represent a huge exposure for states.[22, 23] The probability that these liabilities will devolve are not identical for each state, and thus cannot be treated uniformly in terms of their fiscal impact.[24] As a rule of thumb, assuming that about one-third of such liabilities devolve to the states to service, figure 3.3 presents a broader concept of "extended" debt, that is, debt inclusive of the likely devolvement of outstanding guarantees, to provide an assessment of the exposure and fiscal risk for the states. Extended debt is calculated as direct debt (explicit) plus one-third of the contingent liabilities[25] extended by the state governments (as reported by them). This adds to the stress scenario being faced by the states.

Along with the deterioration in state finances during the second phase (1998–99 to 2003–04) was the fiscal stress experienced by the central government. The combined center-state fiscal deficit rose from 7.3 percent of GDP in 1997–98 to an average of 9.3 percent over the period. Studies indicate that although India has had primary deficits, it has avoided an explosive rise in debt, mainly because of high economic growth rates relative to the interest rate paid on government debt. Milan (2011) analyzed the decomposition of India's public debt trajectory using the method of debt dynamics and concludes that the strong rate of economic growth compared to the interest rate paid on debt helped avoid an explosive debt trajectory. The situation was similar for states' finances, where the lower rate of interest on debt and the higher revenue buoyancy (Thirteenth FC, 126) (from both their own taxes and their share in central taxes) enabled improvements in the fiscal stance.

Figure 3.3 Extended Debt as Share of GDP



Sources: Reserve Bank of India and author's calculations. Latest data on guarantees are available only until 2009.
Note: GDP = gross domestic product, GFD = gross fiscal deficit.

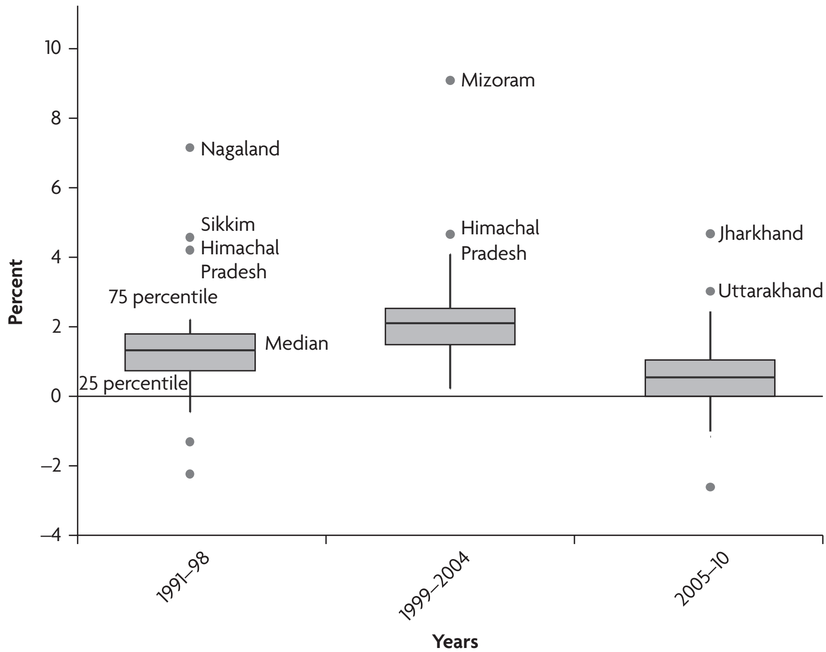
Fiscal correction set in after 2004–05, with the onset of reforms that went beyond the "realm of fiscal space" (World Bank 2004, 11). These included reforms on the expenditure side to contain spending, restrict recruitment, and curb growth in administrative expenditures; and some states cut the cost of pension schemes and reduced subsidies (through power sector reforms), including closure of and privatization of selected PSUs. On the revenue side, reforms aimed to enhance revenue receipts by revising tax rates and broadening the base, while focusing on improving tax compliance. Institutional reforms reflected a paradigm shift, with the adoption of medium-term fiscal frameworks and FRL at the state level (Howes, Lahiri, and Stern 2003).

Much has been written about the reforms to correct the fiscal imbalances and sectoral improvements, including improving the business climate to facilitate growth (World Bank 2003b). The reforms undertaken specifically to restructure or reduce the debt and interest burden, along with those to enhance the credibility of states and ensure sustainability of debt, are discussed in the next section. Since the implementation of reforms in the mid-2000s, the declining fiscal/debt trends have been reversed. However, the 2008–09 global financial crisis has posed challenges.

Another aspect to consider is that, at the macro level, the states' aggregate analysis masks state-level disparities in fiscal performance. The differentiation among state performance persists, but the dynamics change over time, with some states reversing their fiscal decline from the second phase to the third phase (for example, Karanataka and Orissa), while the record of some states continued to deteriorate (for example, West Bengal). Assessing the performance of individual states against the median for the period reveals that in terms of the primary deficit, among the nonspecial category states,[26] Bihar, Chattisgarh, Gujarat, Haryana, Karnataka, Madhya Pradesh, Orissa, Punjab, and Uttar Pradesh have improved fiscal performance (primary balance)[27] since 2004–05 (until 2009–10) compared with the deterioration during 1998–99 to 2003–04 (compared with median values), while Goa, Jharkhand, Kerala, Maharashatra, Uttar Pradesh, and West Bengal continued to have persistently high deficits even during the fiscal correction phase (from 2004 onward) (see figure 3.4).

As expected, most of the states that reflected weak fiscal performance are also plagued with high debt and repayment burdens across the three

Figure 3.4 Primary Deficit as Percentage of GSDP



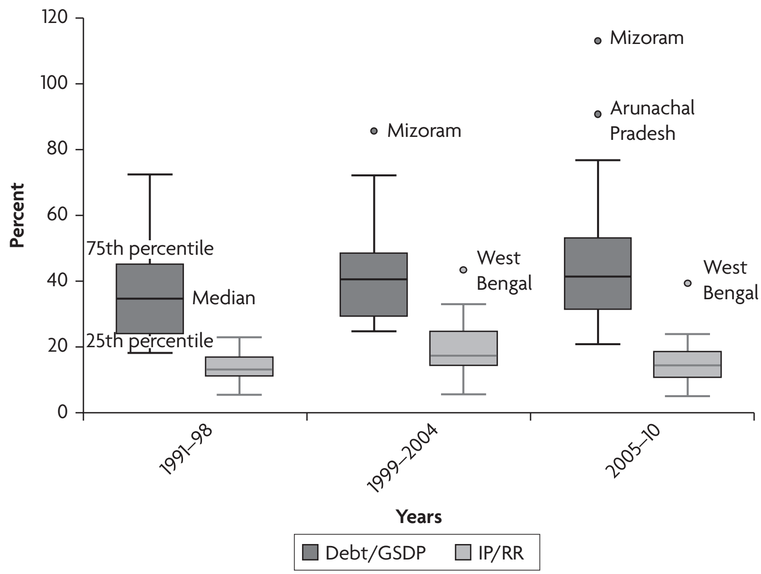
Source: The box plot was created by Stata using data from Reserve Bank of India.

Note: The line in the middle of each box indicates the median (50th percentile); the top of the box indicates the 75th percentile and the bottom the 25th percentile. The lines above and below the box represent the adjacent values, which are within 1.5 times the interquartile range (iqr) of the nearer quartile (75th percentile for the line above and 25th percentile for the line below). The iqr is calculated as the value of the 75th percentile minus that of the 25th percentile. Thus, the largest value (upper end of the upper line) is identified by the 75th percentile plus 1.5 times the iqr, and the smallest value (the lower end of the lower line) is the 25th percentile minus 1.5 times the iqr. GSDP = gross state domestic product.

periods. As can be seen from the box plot in figure 3.5, a large number of states have both debt and interest burden above the 75th percentile across the three periods under study. A case in point is West Bengal, which has persistently had high debt (an average of 45 percent during 2005–10) and a large interest burden (39.3 percent) continuing relentlessly, even during the current period (figure 3.6).

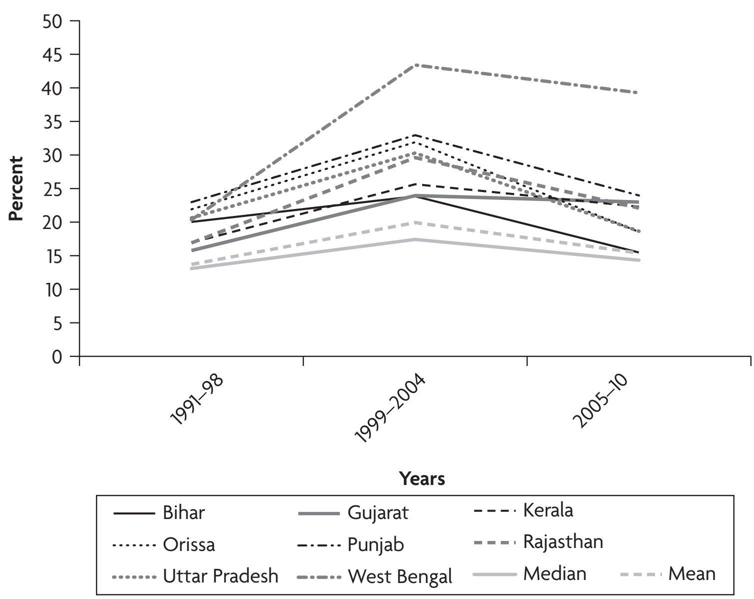
Analyzing vulnerability in terms of debt as a ratio of gross state domestic product (GSDP) and interest burden (payments as a share of each state's revenue receipts) provides a useful indication of the susceptibility that states face. Table 3.3 plots states in a matrix that highlights states facing more vulnerability. Gujarat, Himachal Pradesh, Kerala,

Figure 3.5 Box Plot Showing Debt-to-GSDP Ratio and Interest Burden Ratio



Source: The box plot was created by Stata using data from Reserve Bank of India.
Note: GSDP = gross state domestic product, IP = interest payments, RR= revenue receipts.

Figure 3.6 Interest Burden in Selected States



Source: Authors' calculation using data from RBI reports.

Table 3.3 States' Vulnerability Matrix

		Debt			
		Debt-GSDP Ratio			
Interest payment		**Very high (above 50%)**	**High (30–50%)**	**Medium (20–30%)**	**Low (below 20%)**
Ratio of interest payment to revenue receipts	Very high (above 25%)		West Bengal		
	High (15–25%)	Himachal Pradesh	Gujarat, Kerala, Punjab, Rajasthan	Maharashtra	
	Medium (10–15%)	Jammu and Kashmir	Andhra Pradesh, Bihar, Goa, Jharkhand, Madhya Pradesh, Orissa, Uttar Pradesh, Uttaranchal	Karnataka, Tamil Nadu	Haryana, NCT Delhi
	Low (below 10%)	Arunachal Pradesh, Manipur, Mizoram, Nagaland, Sikkim	Meghalaya, Tripura	Assam	Chhattisgarh

Source: Authors compilation using data from RBI reports.
Note: GSDP = gross state domestic product, NCT = National Capital Territory.

Punjab, Rajasthan, and West Bengal reflect both debt levels of over 30 percent of GSDP and a high interest burden. The combined GSDP of these states accounts for over 12 percent of the national GDP. Their continued struggle with fiscal adjustment poses a challenge, which is further compounded by the global financial crisis (discussed in "Impact of the Global Financial Crisis and Going Forward" section).

In keeping with the diverse fiscal situation in states, the Thirteenth FC recommended a state-specific approach for adjustment based on past fiscal performance (with 2007–08 the base year), and prescribed differentiated adjustment paths for different groups of states. It was estimated that to attain the aggregate target of states' debt-to-GDP ratio of 25 percent, the aggregate fiscal deficit of states should be maintained at 3 percent of GDP. Being an aggregate, however, this target indicator does not reflect the specific realities of individual states. For example, an abrupt reduction in fiscal deficits in states that also had high revenue deficits would lead to undesirable compression in capital expenditures.

Thus, the Thirteenth FC, while keeping a balance between the need for customization with the requirement for adopting a uniform approach for determining targets for all states, recommended a differentiated approach. It was recommended that the nonspecial category states that had a revenue surplus or balance in the base year 2007–08 adopt a road map that eliminated their revenue deficits by 2011–12, and target fiscal deficit to 3 percent of GSDP. Other states with a higher revenue deficit in the base year were to adjust following a gradualist approach to avoid sudden cutbacks in capital expenditures, and eliminate the revenue deficit by 2014–15 and achieve a 3 percent fiscal deficit by 2013–14.[28]

Debt Restructuring and Institutional Reform

The structural deterioration in states' finances led to intense deliberations among stakeholders—parliamentarians, policy makers, think tanks, and other interested parties—about reform options to not only reverse the fiscal decline and lower debt levels, but also to put state finances on a more sustainable path going forward. The fiscal correction in state finances since the mid-2000s thus resulted from interrelated reforms on multiple fronts, helped in large part by the higher reveune buoyancy (Thirteenth FC) and the overall strong economic growth in India. The priority of fiscal consolidation was to restore the balance of revenue accounts—that is, reducing the revenue deficit to zero. The reforms included the standard fiscal consolidation measures through expenditure and taxation reforms. But, importantly, efforts were taken to develop a rule-based institutional framework, including fiscal responsibility laws, to ensure the sustainability of the consolidation. Such a rule-based system complemented the move from central government onlending to the market-based financing mechanism for meeting the states' financing requirements. It was realized, however, that even after lowering the primary deficit, the debt service repayment pressure and high indebtedness would continue, since about 80 percent of states' borrowing in 2003–04 was at high-cost, nonmarket rates.

Research indicates that in addition to the important elements of fiscal consolidation, such as controlling the rapid growth of current expenditures and implementing structural taxation reforms, fiscal consolidation must include the objective of reducing repayment pressure by reducing interest costs (Dholakia, Mohan, and Karan 2004; Prasad, Goyal, and Prakash 2004). The Twelfth FC had also viewed the large interest payments as a major factor leading to the outstanding debt of states, and felt that reducing these payments was integral to attaining debt sustainability. With regard to the broad approach on the issue of debt sustainability, the Twelfth FC was of the view that debt relief measures were required as a prerequisite to achieve revenue balance. Moreover, international experience showed that given the high indebtedness of states, it would be difficult to adhere to the fiscal targets when established by the states' fiscal responsibility law (Liu and Webb 2011). To achieve this would imply reducing both the stock of debt and the cost of borrowing.[29]

However, it was also recognized that debt write-offs, relief, and restructuring alone cannot ensure the sustainability of state finances. Policy makers were cognizant that waivers of loans and interest should be restricted to avoid moral hazard problems and encourage debt repayment discipline. The debt restructuring was thus linked to states undertaking reforms to increase revenue efforts, controlling expenditure, and reorienting expenditures toward supporting growth (Twelfth FC). This section focuses on the debt restructuring program and its links to incentive packages offered to states for undertaking institutional reforms.

Debt Relief and Fiscal Responsibility Legislations

Debt relief had been provided by the waiving of repayment and/or interest payments due, altering the terms of repayment, reducing interest rates, and consolidation of loans. In the 1980s and 1990s, successive FCs had given unconditional debt relief to states, although the relief had been provided only periodically, and the amount of relief was not significant (table 3.4).[30] Thus, states have had to repay most of the debt they incurred. The Tenth and Eleventh FCs started to link debt relief with fiscal performance.[31] However, it was not until the Twelfth FC that debt relief was linked explicitly to rule-based legislative reforms. In a pathbreaking move, the Twelfth FC recommended debt relief for states contingent upon the enactment of fiscal responsibility laws and

Table 3.4 Debt Forgiveness by Finance Commission

Finance Commission	Year of report	Rs (billion)	GDP Rs (billion)	% of GDP
Sixth	1974	20	667	2.95
Seventh	1979	22	1,025	2.11
Eighth	1984	23	2,223	1.03
Ninth	1989	10	4,357	0.22
Tenth	1995	5	10,672	0.05
Eleventh	2000	34	20,050	0.17
Twelfth	2005	535	31,494	1.70

Sources: McCarten 2001; Report of Thirteenth Finance Commission 2009.
Note: GDP = gross domestic product.

incorporation of a fiscal correction path, with milestones for attaining fiscal targets while improving the current (revenue) balance (reducing the deficit to zero by 2008–09).

To implement the recommendations of the Twelfth FC, the Debt Consolidation and Relief Facility was introduced during 2005–06, which provided debt relief through consolidation, rescheduling repayments for a fresh term of 20 years, and lowering of the interest rate on the debt to 7.5 percent. All states were eligible to obtain relief from the year they enacted FRL. This amounted to Rs 187 billion in terms of lower interest payments, and Rs 211 billion in terms of lower repayments, totaling Rs 398 billion (US$8.9 billion[32]) during 2005–06 to 2009–10. In addition, repayments due during 2005–10 on central loans contracted up to March 31, 2004, (after consolidation and rescheduling) were eligible for write-off subject to the reduction in revenue deficits. The debt write-off would also be subject to containment of the fiscal deficit to the 2004–05 level. Subject to these provisions, if the revenue deficit were brought down to zero by 2008–09, all repayments during 2005–10 would be written off.

Carrying forward the momentum to support states toward urgent fiscal correction, the Thirteenth FC worked out a differentiated fiscal adjustment road map (described in the previous section), with a state-specific approach based on past fiscal performance (using 2007–08 as the base year) for different groups of states. A key requirement is that all states eliminate their revenue deficits (the deficit on current balance), but they can have a fiscal deficit of 3 percent of GSDP by

2014–15, along with a reduced debt target of 24.3 percent of GDP in the same year (from 27 percent in 2008–09). The debt relief granted was similar to the Twelfth FC; all loans to states from the Government of India outstanding as of 2009–10 would be written off if the state enacted or amended its FRL. Moreover, interest on past NSSF loans (contracted during 2006–07) was reduced to 9 percent from 9.5 percent.

The center enacted the Fiscal Responsibility and Budget Management Act in 2003, with applicability only to the national government. Some states had also enacted their own FRLs before the center (for example, Karnataka and Punjab, in 2002), and many states had since 2003 adopted FRLs in line with the national law. The Twelfth FC subsequently mandated that states pass FRLs to avail themselves of the benefit of debt relief, with revenue deficits (total revenue minus current expenses) to be eliminated and fiscal deficits to be reduced to 3 percent of GSDP by fiscal year 2009.[33] Since then, all 28 states have passed FRLs, most of which require the state to present a medium-term fiscal plan with multiyear rolling targets for key fiscal indicators, along with the annual budget, to the state legislature. Some of the FRLs, passed by states, also place limits on guarantees; others mandate the disclosure of contingent liabilities and other borrowing. Most FRLs require disclosure of significant changes in accounting policies.

Fiscal targets adopted by Indian states are remarkably similar to each other with respect to fiscal and revenue deficits. Some states adopted additional legislation on fiscal targets, such as the Kerala Ceiling on Government Guarantee Act (2003), which was enacted the same year as its FRL. According to the Guarantee Act, the guarantee outstanding for any fiscal year shall not exceed Rs 140 billion,[34] no government guarantee shall be given to a private entity, and the Guarantee Redemption Fund shall be established. Other initiatives included the setting up of (a) the Consolidated Sinking Fund (1999) to provide a cushion for repaying market loans of states (20 states have established this), (b) the Guarantee Redemption Fund (2001) to provide a cushion for servicing any contingent liabilities because of guarantees issued by state governments to its PSUs (11 states have established this), and (c) several technical committees and working groups on topical issues of cash and debt management.[35]

Debt Swap and Securitization: A Move toward Market-Based Financing

The fiscal correction was given an impetus with the introduction of a "debt swap scheme" during 2003–04 to lower the existing interest burden and increase market access. Loans from the center amounting to Rs 1,000 billion (US$23 billion[36]) with interest rates in excess of 13 percent were substituted with new market loans and small savings proceeds at lower rates of interest; the outstanding debt remained unchanged. The market conditions prevailing were fortituous and the rates were significantly lower, at 7.5 percent (RBI State Finances Study 2004–05, p. 24), enabling an interest savings for states of Rs 310 billion (US$7.1 billion[37]) and 0.75 percent per year in revenue (Twelfth FC). This direction toward the market was reaffirmed by the Twelfth FC in conjunction with state debt relief, where it stated, "As regarding the future lending policy, the central government should not act as an intermediary and allow the states to approach the market directly" (Twelfth FC, 236).

States issued "power bonds" to securitize the fiscal risks emanating from the losses of electricity utilities arising from the gap between the cost of producing power and the tariff charged. This gap between the cost and tariff had resulted in significant losses and an accumulation of arrears. With the securitization, arrears and accrued interest at about 1.5 percent of GDP were cleared by states through the issuance of 15-year tax exempt "power bonds."[38] Cognizant of the moral hazard issue, this was clearly announced as a one-time settlement measure and was supplemented with reforms to ensure discipline going forward. Participating states qualified for funds on the basis of reform milestones and improvements in the reduction of commercial losses. Although state liabilities had increased by 22.8 percent during 2003–04 at the time of issuance of these bonds, many states have prepaid, and only Rs 144.23 billion (US$3.23 billion[39]) remained as of end-March 2011.

In addition to the above debt restructuring program to link with institutional reform and move toward market access, the role of the RBI is also important. First, as the regulator of the banking sector, the RBI sets the statutory requirements for banks to hold state debt. This increases the acceptability of state securities by the market. Second, the RBI tightened the regulation for use of the overdraft facility by states. Previously, states had resorted to the facitily as a way to roll over short-term borrowing to finance structural deficits. The terms and conditions for facilty use were formula based and specified. Moreover, the use of the facility by the states is disclosed to the market on an ex-post basis. For example, the market has information on the better performers compared to the chronic-deficit states (table 3.5 shows that Punjab, Uttarkhand, and West Bengal depended on this facility during 2010–11 to meet their temporary resource gap). Such information influences market sentiment and spreads, while lowering credit ratings.

The intent of the FRL, debt swap, securitization, and the move toward market operation was to support the fiscal discipline reform at

Table 3.5 States' Overdrafts and Access to Cash-Credit
Number of days

	Special WMA		Normal WMA		Overdraft	
	2009–10	2010–11	2009–10	2010–11	2009–10	2010–11
Andhra Pradesh	1	3	—	—	—	—
Haryana	7	10	5	10	—	8
Kerala	18	—	2	—	—	—
Madhya Pradesh	11	—	11	—	—	—
Maharashtra	—	—	—	—	—	—
Karnataka	—	—	—	—	—	—
Nagaland	69	—	45	—	13	—
Punjab	130	133	128	132	29	13
Rajasthan	—	—	—	—	—	—
Uttar Pradesh	8	4	8	4	—	—
West Bengal	95	195	15	113	8	62
Himachal Pradesh	—	—	—	—	—	—
Manipur	—	—	—	—	—	—
Mizoram	29	25	15	15	—	—
Goa	—	—	1	—	—	—
Uttarakhand	69	35	26	12	9	10
Meghalaya	—	1	—	—	—	—
Jharkhand	—	—	—	—	—	—

Source: Reserve Bank of India, *Annual Report 2010–11*.
Note: WMA = ways and means advances. Normal WMA is formula based, special WMA is after access to normal WMA but is collateralized. — = no access to facility and strong cash management position.

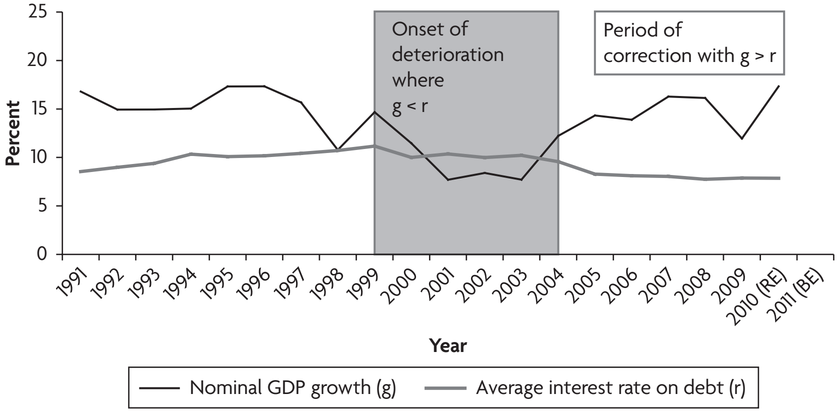
the state level to reverse the structural decline of state finances from the late 1990s to the early 2000s. It will be difficult to precisely evaluate the direct impact of these reforms. In this context, a study by Liu and Webb (2011) concludes it would be difficult to precisely separate and measure the effects of the FRL given the lender-borrower nexus and various channels that would influence government fiscal deficits and indebtedness. Nonetheless, it was noted that to the extent the FRL intends to improve government finance and avoid over-indebtedness, it is worthwhile ascertaining whether FRL has been associated with improved fiscal outcomes.[40]

Liu and Webb (2011) choose growth of public debt before and after passing subnational FRL in several countries, including India. The measurement of the fiscal improvement or deterioration was normalized, since each state government might have passed its FRL in different years. The paper shows that in Indian states, the growth of debt to GSDP was slower in the post-FRL period than in the pre-FRL period for 24 of 26 states. Twenty-one of these 24 states had reversed the trend of increasing debt to GSDP in the pre-FRL period.

A study on the "Dynamics of Debt Accumulation in India" (Rangarajan and Srivastava 2008) pointed to the fact that accumulation of debt can be seen as the result of the balance between cumulated primary deficits and the cumulated weighted excess of growth over interest rate. Decomposing the change in the central government's liabilities relative to GDP shows that a significant part of the cumulated primary deficit could be absorbed due to the excess of growth over interest rates. However, this cushion is not always available, and the sharp increases in debt relative to GDP during 1997–2003 were because of both factors, that is, cumulated primary deficit and excess of effective interest rate over growth rate.

One study (Milan 2011) shows that strong economic growth relative to the interest rate paid on government debt helped India avoid an explosive rise in debt despite the existence of successive primary deficits. The same holds true for the aggregate performance of states; figure 3.7 shows that the fiscal correction phase in states also coincides with a higher GDP growth rate and lower rate of interest paid on state debt. This was also in part the result of fiscal correction, which led to a reduction in government dis-savings and debt. This,

Figure 3.7 Differential between GDP Growth Rate and Interest Rate on State Debt



Source: Authors' calculation using base data from RBI.
Note: BE = budget estimates, GDP = gross domestic product, RE = revised estimates.

however, masks the varied fiscal performance of individual states, which has been mixed over the period, causing concern in the context of the global crisis.

Impact of the Global Financial Crisis and Going Forward

Although the immediate impact of the global financial crisis on state finances was somewhat subdued, there are implications going forward. The challenges will be more on the resource side through reduced central transfers, accentuated by the low-cost recovery by states. These may well render difficult the achievement of the Thirteenth FC road map. Going forward, sustainable finances require states to undertake reforms to maintain solvency via, among other things, increases in own taxes, implementing a goods and services tax, and revising tariffs.

Assessing the impact of the crisis on the center, the immediate impact was relatively "muted" (Milan 2011[41]; RBI 2011a). Although there was a setback in the growth of the economy, the bounce back was swift and impressive (Reddy 2011). The countercyclical fiscal and monetary policy actions and, more critically, the high-growth trajectory that was maintained at over 7 percent during 2009–10 and over 8 percent during 2010–11 helped minimize the impact ("World Bank Economic Update," September 2011). The initial conditions—the relatively low external debt, the high foreign exchange reserves, and selective capital controls—helped reduce the impact of the external shocks. Nevertheless, worries remain because of the high general government deficit and public debt levels.[42] It is widely acknowledged that high levels of deficit and debt reduces "elbow room" and the ability to borrow and respond to such shocks and extreme events.

On the growth front, a slowdown in the next two years is anticipated (World Bank 2011),[43] as a result of uncertainties weighing down investment, tighter macroeconomic policies intended to contain inflation, and the base effect of the strong agricultural rebound during 2010–11. Slow growth in core Organisation for Economic Co-operation and Development countries implies that the domestic drivers for growth will need to be strengthened. Moreover, there is a realization that concerted efforts will be necessary to avoid fiscal slippages by the center during 2011–12, especially if the rise in commodity and fuel prices continues at an elevated level. The sustainability of the fiscal stance will, however, need measures to control, if not compress, expenditures along with revenue augmentation.

Turning to the states, the impact of the global crisis got intertwined with the wage rise, and the fiscal situation deteriorated during 2009–10. On the revenue front, there was a reduction in revenue receipts during 2008–09 and 2009–10, reflecting a fall in the state share of central taxes, which had been affected by the economic slowdown. There was also a deceleration of agricultural output that coincided with the crisis and could in part explain the revenue falls in some states. Expenditures rose primarily because of the revision of pay and salary arrears, which coincided with the crisis years. Of 17 nonspecial category states, 11 had current balance deficits, while the overall fiscal deficit widened in all states except Jharkhand and Kerala.

The impact on the management of state debt was, however, insignificant, reflecting in part the strengths of the state borrowing regime, with its ban on borrowing abroad; the limited history of bailouts; and the enactment of FRLs. During 2008–09 and 2009–10, countercyclical measures were taken by states to mitigate the impact of the crisis on domestic economic activity. These included relaxing the deficit levels to 3.5 percent of GDP (from 3 percent legislated under the FRLs). Further, the center allowed states a larger share of market borrowings to compensate for the unprecedented impact of exogenous factors on the fiscal situation. Concomitantly, states increased market borrowings by 34.6 and 28.6 percent during 2008–09 and 2009–10, respectively, compared with the increase of 23 percent during 2007–08. Interestingly, a positive impact of this was an improvement in the interest profile of states, with the share of high-cost market loans (with an interest rate over 10 percent) declining further during 2009–10.

It needs to be emphasized, however, that macroeconomic stabilization and countercyclical policy actions are the key responsibility of the center and not of subnational governments. Accordingly, the Thirteenth FC recommended that instead of raising the borrowing limits for states in the event of such shocks, the center should assume the entire responsibility for the additional resource mobilization and pass these to states in the form of increased devolution. This (formula-based) devolution will meet the differential requirements of the states in terms of both fiscal capacity and fiscal need.[44]

Much of the deterioration in the fiscal position of the states during that period was temporary, and thus could be attributed to deterioration in the share of central taxes because of the crisis and arrears of pay revision (Reddy 2011). Although the fiscal deficit had deteriorated to 3.3 percent of GDP during 2009–10, indications were positive for a turnaround in 2010–11, as reflected in the study of aggregate state budgets by the RBI. It also appears that fiscal discipline at the state level may have acted as a source of comfort for the market. This is corroborated by the fact that after witnessing some stress during the initial period of the global financial crisis, most states reverted to the path of fiscal consolidation, with lower deficit ratios during 2010–11.

In sum, even though the immediate impact of the global financial crisis on state finances was somewhat subdued, this has implications going forward. The challenges are likely to emerge through the reduced impact of central transfers, given that the center's deficit has not shown signs of abatement. The overall current transfers to states are budgeted to decline by 0.4 percentage points of GDP during 2010–11 (RBI 2011a). Going forward, sustainable state finances requires reforms to increase states' own tax revenues by speedily implementing the goods and services tax. Implementation of this tax is expected to reduce vertical imbalances, with states being able to tax the services sector (the fastest-growing sector, which accounts for over 65 percent to GDP), and provide gains to India's GDP of 0.9 –1.7 percent (Thirteenth FC).

States also need to review their tariff polices, particularly in power and irrigation, to ensure that the gap between costs and recovery is narrowed, if not closed. It is estimated that for the power tariff, even for the best-performing states, increases of 7 percent per year are required to bridge the cost-to-recovery gap, while the not-so-good performers require increases of almost 19 percent per year (Thirteenth FC). If not rectified, these issues will render the achievement of the Thirteenth FC road map difficult.

Another critical issue is that, although in the aggregate, states have contained their fiscal accounts, the impact needs to be evaluated in the context of the contingent liabilities, which include not only guarantees, letters of comfort, and liabilities of state-owned enterprises, but also implicit contingent liabilities arising due to vulnerabilities in the state PSUs and pensions. Especially if tight liquidity conditions impact the health of the state-owned enterprises and PSUs, fiscal risks could spill over onto states' fiscal positions. Although these must be addressed more from the perspective of the fiscal risks that arise from such contingent liability, it is important to keep them in mind.

Conclusions

Although states have faced fiscal stress, systemic insolvency and defaults have not occurred because of a mix of factors. The significant growth rates of the Indian economy in the late 1990s and 2000s have also played a critical role in alleviating the interest burden on debt and ensuring that the debt does not grow in an explosive trajectory. The serious efforts at fiscal consolidation and institutional reforms enabled states to get on the path toward fiscal correction. In addition, the restriction on borrowing and the constitutional arrangements enabled the onset of fiscal correction in an appropriate manner.

Furthermore, lowering the interest burden on debt was important in enabling the states to pursue a sustainable course. The approach to debt relief, linked with incentives to implement reforms, has greatly helped avoid moral hazard problems. However, while the focus has been mainly on direct debt obligations, contingent liabilities pose a serious fiscal risk on states finances, unless monitored and adequately controlled. Moreover, the aggregate picture masks interstate disparities and vulnerabilities, which require customized reforms and correction packages rather than a "one-size-fits-all" approach.

The change in lending policy and patterns of borrowing has provided greater flexibility, but also more responsibility to states, with market discipline becoming an important plank. The greater access to resources from the market requires more active debt management and strategy development, using robust analysis to ascertain the cost risk of the debt portfolio. Strengthened debt management capacity institutional arrangements at the state level, with a more active risk management approach, will be required to meet future challenges.

Although the global financial crisis has had a relatively insignificant impact on Indian states, policy makers must always be cognizant of the fact that despite an absence of systemic insolvency and defaults, high debt reduces the maneuverability and flexibility of policy to respond. However, it needs to be emphasized that countercyclical policy is the responsibility of the federal government and not of subnational governments. If the fiscal deficit targets are to be relaxed at all to overcome cyclical downturns, then that should be done by the federal government, which can increase its borrowing and pass it on via higher devolution and grants to the subnational governments. This means that the subnationals' fiscal deficit targets are unchanged. Fiscal challenges remain and are likely to be critical if the rise in commodity and fuel prices continues at an elevated level. There are concerns that growth might slow to 7–8 percent in the next two years (World Bank 2011). This could generate the dilemma of needing to compress expenditures for ensuring fiscal sustainability while simultaneously needing countercyclical spending to boost growth.

Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

1. The word "states" is used interchangeably in this chapter with "state governments" and refers to the total data and performance of the 28 state governments in India.

2. In Indian fiscal accounting, revenue balance refers to current balance, that is, total revenue minus current expenditures.
3. The FC is a constitutional body appointed every five years or sooner to review the finances of the center and state governments and recommend devolution of taxes and other proceeds from the center to the states (vertical transfers) and among the states themselves (with the objective of horizontal equity).The FC uses a formula-based approach, assigning weights for various relevant factors such as population, income disparity, area, tax effort, and fiscal discipline. These weights have changed over time. There have been thirteen FCs since independence.
4. See Ianchovichina, Liu, and Nagarajan 2007; Pinto and Zahir 2004; Rangarajan and Srivastava 2008; Reddy 2000; and World Bank 2004.
5. The share of debt of the local governments—the third tier of government—is not covered in this chapter. Local government debt in India is small. Local governments, with limited fiscal autonomy, are largely dependent on fiscal transfers and onlending from higher levels of government.
6. These were added in the 73rd and 74th Amendments to the Constitution. The Seventh schedule to the Constitution specifies the legislative, executive, judicial, and fiscal domains of Union and State governments in terms of Union, State, and concurrent lists.
7. The "financial relations between the Centre and the States are designed with great care and circumspection … to forestall precisely the kind of difficulties that even the older federations do not appear to have overcome in securing closer correspondence between resources and functions of the different layers of Government" (Sixth FC).
8. Over time, the FCs have taken various approaches to addressing state concerns regarding the composition of the divisible pool of central taxes and inter se allocation criteria between and among states. Although FCs have aimed to foster fiscal stability among the states, an empirical analysis reveals that although transfers have helped to reduce the overall gross fiscal deficit of the states, horizontal fiscal inequity is yet to be addressed (Kannan et al. 2004).
9. RBI, "State Finances: A Study of Budgets," 2007, p. 58.
10. Solvency refers to the government's ability to service its debt without defaulting. It is defined as the condition that the state government's net stock of debt does not exceed its ability to pay off that debt at some time in the future (measured by the present discounted value of its future primary surpluses). Liquidity is the ability to meet short-term cash needs (within the year); that is, in each period the state government has enough resources (flows) to cover expenditures plus debt service. Debt is considered unsustainable if it will lead to insolvency in the future (see Ley 2010). Also important is the concept of credibility, or the confidence of investors that solvency and liquidity will be maintained.
11. External loans are project-based loans, except for some structural adjustment loans, usually from multilateral development banks at concessional terms.

12. Since 2006, the Standing Technical Committee, with representation from the center, states, and the RBI, has been making annual projections of states' borrowing requirements. The committee considers several factors including the macroeconomic and financial conditions, sustainability of debt, provisions of FRL, and fiscal risks from issuance of guarantees.
13. India used to have a system of planned development under which grants and other assistance was provided to states.
14. It may be argued that because India still has a large fiscal deficit, this effectively crowds the private sector. But banks are not required to hold more than 25 percent of their net deposits in liquid liabilities such as government securities. Banks, however, hold a higher percent, which goes to the question of demand for credit offtake from business.
15. The central government temporarily allowed states to increase the fiscal deficit to 3.5 percent of GSDP during 2008–09 and to 4 percent during 2009–10 in response to the global financial crisis (Canuto and Liu 2010).
16. The NSSF was established in April 1999; small savings collections are invested in central and state government special securities. At present, 80 percent of all small savings collections within a territory of a state are invested in the same state securities. This adds to the debt of the state but is not controlled by the center. Moreover, the inflows are autonomous and depend on the spread between the small savings rate and the deposit rate. See "Report of the Committee on the Comprehensive Review of the National Small Savings Fund," June 2011. There is an inflexibility associated with NSSF borrowing, since these are based on availability and not necessarily on the requirement by the state to borrow, and are at higher interest costs and with an asymmetry toward the center (Thirteenth FC, 144).
17. The Twelfth FC stated that "… as regards the future lending policy, the central government should not act as an intermediary and allow the States to approach the market directly." The practice of onlending from the center has been discontinued since then (recommendations of the Twelfth FC were accepted in May 2005).
18. These studies are quoted in Bose, Jain, and Lakshmanan (2011).
19. Interest payments as a ratio of revenue receipts provide an explanation of the interest burden and the level of "tolerable" debt. Debt is said to be tolerable if servicing it does not impose an intolerable burden on the fiscal position. Dholakia, Mohan, and Karan (2004) analyzed what interest burden a state can tolerate as a proportion of its revenue receipts. In 2004, Dholakia, Mohan, and Karan used one-fifth of revenue receipts as a tolerable ratio. The FC also considered the same.
20. In India, government wages are reviewed and revised periodically, usually every 10 years.
21. "The Report of the Group to Assess the Fiscal Risks of State Government Guarantees," (RBI, July 2002) reported that guarantees grew at an average rate of 16

percent per year during 1992–2001 (paragraph 5). To avoid an escalation of the fiscal risks, the RBI had issued regulatory guidelines to banks (which were the major investors) to only invest in state public sector undertakings (PSUs) if there was a clear revenue stream from the PSU/project, rather than that accruing from the state government budget. In addition, all the PSU issues were to be rated by at least two domestic credit rating agencies if banks were to invest in them. Also, such investments had credit risk weights and provisioning requirements.

22. Thirteenth FC, p. 103.
23. A 2011 note by Citi Investment Research and Analysis indicates that the total losses of state electricity boards in 2010–11 were Rs 635 billion, and those from five states (Bihar, Madhya Pradesh, Rajasthan, Tamil Nadu, and Uttar Pradesh) account for about 71 percent of the total losses.
24. "The Report of the Group to Assess the Fiscal Risks of State Government Guarantees," (RBI, July 2002), calculated the sectoral default ratios in 2001. The power sector was 15.09 and industry was 39.19. The total default ratio was 3.7.
25. These relate only to those that are reported by the states. Indirect and implicit liabilities, although a source of fiscal risk, are not included here. A comprehensive review is difficult because of inconsistencies and gaps in data coverage and definitions, and is not the remit of this chapter.
26. The focus of this analysis is on the general or nonspecial category states, since they account for almost 95 percent of the total of all states' GSDPs and over 92 percent of India's population.
27. Analyzed as the average of the indicator with reference to the median values during the period of study.
28. All special category states with a base fiscal deficit of less than 3 percent of GSDP during 2007–08 could incur a fiscal deficit of 3 percent during 2011–12 and maintain it thereafter. Manipur, Nagaland, Sikkim, and Uttarakhand should reduce their fiscal deficit to 3 percent of GSDP by 2013–14.
29. The Twelfth FC states that "[L]arge interest payments have been a major factor leading to the increase in the outstanding debt of state governments . . . and therefore, the reduction in interest payments is integral to attaining debt sustainability …" (p 226). Dholakia, Mohan, and Karan (2004) conclude that the reduction in effective interest rates was an important factor for the interest burden (interest payment to revenue receipt [IP/RR]) to be at a tolerable level and debt to be sustainable in the states. This required a reduction in both the stock of debt and its costs.
30. The share of debt relief in GDP has declined from 2.95 percent in the Sixth FC to 0.17 percent in the Eleventh FC, indicating a decrease in the relative commitment to central debt forgiveness over time (McCarten 2001).
31. The Eleventh FC linked a portion of the untied central grants to the fiscal correction of the individual states as part of the Fiscal Reforms Facility. Although the grants were small, at Rs 106.07 billion (US$2.43 billion equivalent), they

helped trigger useful reforms (using an exchange rate at the end of the 1st quarter of 2000 of Rs 43.62 = US$1.0).

32. The average of the quarterly average exchange rates from the 2nd quarter of 2005 to the 1st quarter of 2010 is used (from the IFS), which is Rs 44.64 = US$1.0.
33. The summary of Fiscal Responsibility Laws in Indian states is based on Liu and Webb (2011) and the RBI State Finances report.
34. About US$3 billion, assuming an exchange rate of Rs 46.7 = US$1.00.
35. These include issues relating to debt sustainability, model FRL, pension liabilities, state-government-guaranteed advances and bonds, fiscal risk of state government guarantees, voluntary disclosure norms for state governments, state government guarantees, and methodology for compilation of outstanding liabilities and periodic revisions in the ways and means advances limit.
36. Using the end of March 2004 exchange rate at Rs 43.445 = US$1.0. (*Source:* IFS)
37. At an exchange rate of Rs 43.445 = US$1.0.
38. Settlement of state electricity boards dues, May 2001; and "State Fiscal Reform in India: Progress and Prospects," World Bank (2005). The balance accrued interest at Rs 100 billion, which was written off (see chapter by A. Rastogi, in the *India Infrastructure Report 2004*, 24).
39. Exchange rate as of end-March 2011 at Rs 44.65 = US$1.0 (*Source:* IFS)
40. Corbacho and Schwartz (2007) discuss the problems of determining the direction of causality. Their study compared national fiscal deficits in countries with and without FRLs, and found that the former had smaller deficits. Data on subnational deficits for such cross-country comparisons, however, are not readily available.
41. "Fiscal Policy for Growth and Development in India: A Review," Milan et al. 2011 (forthcoming).
42. The high fiscal deficits for the general government, which averaged around 8 percent of GDP in the 1990s and 2000s, are expected to have reached 10 percent of GDP in 2009–10, with debt averaging over 80 percent of GDP in the 2000s (World Bank, September 2011).
43. "World Bank India Economic Update," September 2011.
44. Thirteenth FC, 136.

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4

Subnational Debt Management in Mexico: A Tale of Two Crises

Ernesto Revilla

Introduction

Mexico has experienced two major macroeconomic crises in the last two decades. The 1994–95 Tequila Crisis and the 2008–09 global financial crisis had important implications for the functioning of subnational debt markets. In the Tequila Crisis, the macroeconomic shock affected subnationals through higher interest rates on their debt and the simultaneous reduction in their federal transfers. These shocks made their debt unsustainable, and the federal government intervened with an ambitious restructuring program. In 2009, the global crisis did not affect interest rates in Mexico, but the slowdown in economic activity and the decline in the price of oil reduced federal transfers to subnationals considerably, dramatically affecting their repayment capacity. In this context, an innovative mechanism was designed to smooth the shock and ensure the sustainability of local public finances. These episodes hold important lessons for policy makers interested in designing debt management mechanisms for subnational debt in developing countries. They also shed light on the behavior of subnational debt markets in periods of stress, and policy responses that can be used in dealing with recovery during a crisis.

This chapter contributes to the study of the Mexican Fiscal Federalism Framework in Mexico. While Giugale and Webb (2000) and Revilla (2012) presented general overviews of Mexican intergovernmental relations, this chapter is part of a new wave of efforts to study aspects of intergovernmental fiscal relations in the country. In particular, it adds to the few studies that have been done on subnational debt in Mexico. Among these, Giugale, Korobow, and Webb (2000) describe the "new subnational regulatory framework in Mexico," in place since 2000. In addition, Hernández, Díaz-Cayeros, and Gamboa (2002a) study the determinants and consequences of the 1995 bailout, while Giugale, Hernández, and Oliveira (2000) give an overall overview of the subnational debt market at the dawn of the century.

This chapter more closely relates to the literature on subnational debt restructuring, as in Liu and Waibel (2009); Prasad, Goyal, and Prakash (2004); and Ter-Minassian and Craig (1997). In particular, it adds a developing country dimension to those studies of subnational debt markets after the global crises, such as the ones in Canuto and Liu (2010a, 2010b). Together with the other chapters in this volume, this chapter sheds light on the very difficult questions and dilemmas that policy makers face when dealing with subnational debt markets after macroeconomic crises, especially in developing countries.

The chapter is structured as follows. Section two describes the Mexican fiscal federalism framework. Section three describes the restructuring of subnational debt after the Tequila Crisis. Section four describes the response after the global crisis. Section five discusses the similarities, differences, lessons, and conclusions for subnational debt management.

The Fiscal Federalism Framework in Mexico

All intergovernmental fiscal relations systems are different and constrained by the local culture, politics, and the economics of the institutional setup. Mexico's fiscal federalism is defined by a very large vertical imbalance, an enormous dependence of subnationals on federal transfers, and on a low level of subnational debt, all of which influenced the objectives and constraints of the policies implemented during the two crises discussed in this chapter.

Mexico is a federal country divided into 31 sovereign states and one federal district. Each state is composed of municipalities, which are the basic political unit and which have some sovereign autonomy over their political and fiscal development. Being political subdivisions of states, municipalities are extremely heterogeneous in their level of development.[1] The fiscal federalism framework in this three-tier government structure consists of the set of laws, rules, and institutions that allocate spending and tax responsibilities, and the transfers and the institutional framework for subnational debt.

A salient feature of Mexico's fiscal federalism framework is the strong dependence of state and municipality finances on federal transfers (see, for example, Giugale and Webb [2000], Revilla [2012], and references therein). On average, the share of resources from federal sources accounts for 85 percent of total revenues for subnationals. This strong dependence on federal resources has remained mostly constant over time. This feature of Mexico's federalism is the main characteristic that determines the politics and economics of current and future reforms on the subject.

Table 4.1 shows the composition of the annual flow of resources to subnationals in Mexico. As can be seen, around 85 percent of revenues for states and municipalities come from federal transfers, around 11 percent from own-source revenues, and borrowing accounts for only 5 percent of annual flow, on average. Federal transfers can be grouped into three main channels: (a) earmarked transfers; (b) nonearmarked transfers; and (c) a smaller, but growing, component of new transfers for specific purposes and infrastructure.[2]

Nonearmarked transfers, called *participaciones*, are the biggest item in states' budgets and the biggest line item in the federal budget. They consist of a set of funds that vary in size and composition. The biggest one accounts for 86 percent of the total and is called the General Participation Fund (Fondo General de Participaciones). It is calculated as 20 percent of a federal pool of revenues that are shared[3] and distributed according to a formula that correlates per capita transfers to the level of economic activity (measured by growth in states' gross domestic product [GDP]) while giving incentives to increase own-source revenue.[4] The rest of the funds are smaller and include a fund for municipalities, one to give incentives to improve tax administration

Table 4.1 Subnationals'[a] Resources in Mexico
billion pesos 2006–10

	2006	2007	2008	2009	2010	Composition[b] (%)	As % of GDP[b]
Total resources	895	911	1,080	1,100	1,169	100	8.9
Federal transfers	785	781	943	936	973	83	7.4
Nonearmarked transfers (*participaciones*)	329	333	423	421	437	37	3.3
Earmarked transfers (*aportaciones*)[c]	388	379	420	439	461	39	3.5
Other[d]	68	70	99	76	74	6	0.6
Convenios	44	56	73	76	74	6	0.6
Excedentes	24	13	26	—	—	0	0.0
Own-source revenue	93	103	120	116	133	11	1.0
Financing[e]	17	26	17	49	63	5	0.5
Memorandum items							
Federal budget	2,264	2,486	2,861	2,817	2,960	100	23
Federal nonoil revenue	1,015	1,205	1,358	1,508	1,492	50	11

Sources: Ministry of Finance; Mexico and states' public accounts.
Note: — = not available, GDP = gross domestic product.
a. States and municipalities.
b. Values correspond to 2010.
c. Includes resources for education expenses in the Federal District, where education has not been decentralized.
d. Includes special decentralization agreements and excess revenue surplus.
e. Corresponds to registered debt with the Ministry of Finance and includes all debt approved by local legislatures; it does not include short-term loans (for cash management) or contingent liabilities (that is, pensions).

at the local level, compensatory funds for states where oil is extracted, and a redistributive fund for the 10 poorest states. For a complete description, see table 4A.1.

Earmarked transfers, called *aportaciones*, consist of eight funds and are itemized in "Ramo 33"[5] of the federal budget. There are special funds for education, health, social development, and public security. The biggest one is the Fund for Basic Education, which accounts for 59 percent of the total. This fund, and the Fund for Health Services (*Fondo de Aportaciones para los Servicios de Salud*), is meant to cover the wage bill for paying teachers and medical professionals who were transferred to states in the 1990s with the decentralization of education and health. There is widespread agreement that the large amount of money spent through these funds has not contributed to more efficient service delivery, that the assignments among states are extremely inefficient, and that there is some level of corruption in the spending of these resources (see IMCO 2010). For a complete description of earmarked transfers, see table 4A.2.

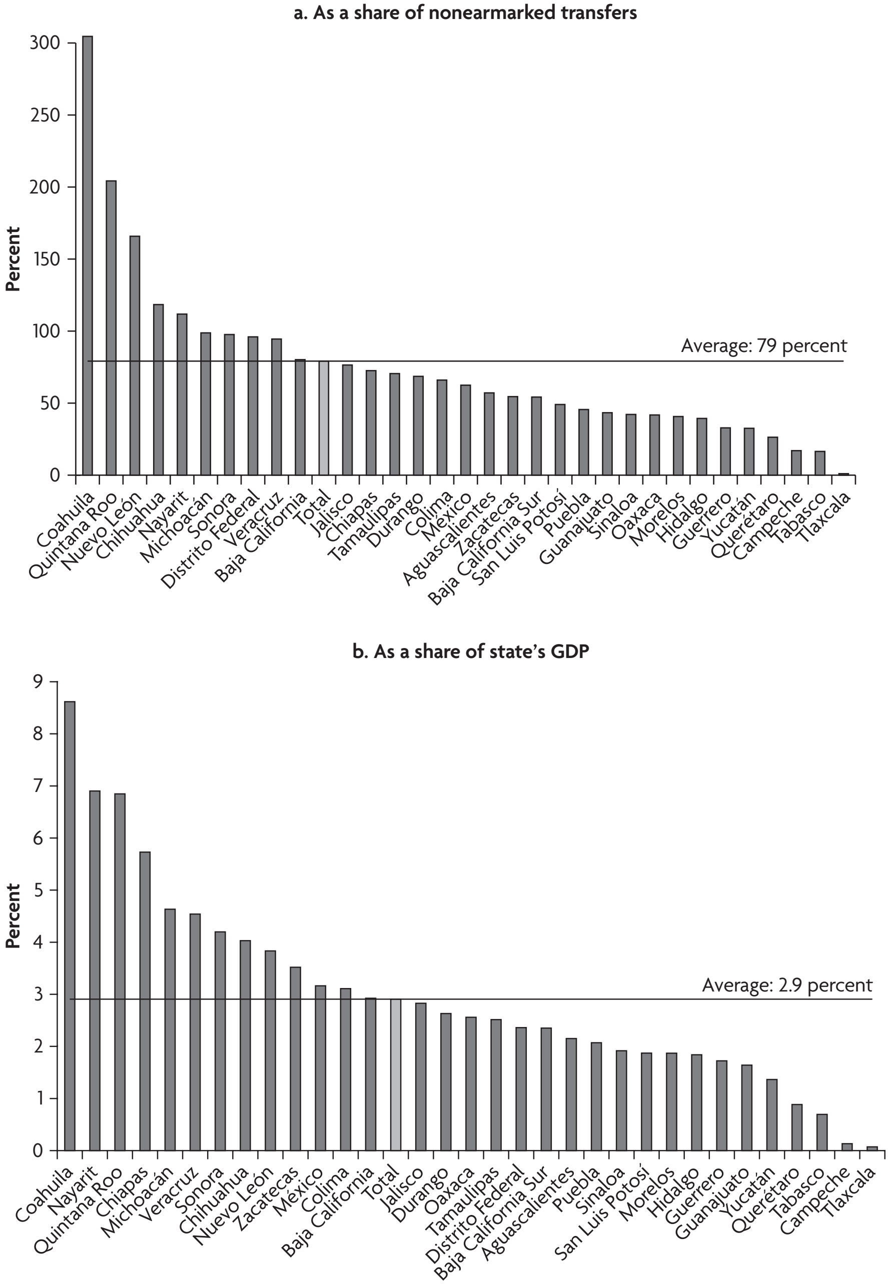
Regarding own-source revenues of subnationals in Mexico, the first salient fact is the low level of own tax effort by states and municipalities. The level of subnational own revenue is low by international standards and relative to its potential. The main tax handle of municipalities is the property tax. Mexican municipalities collect 0.2 percent of GDP. This figure is the lowest in Latin America (Bolivia collects 0.3 percent of GDP, Brazil 0.7 percent, Colombia 1.3 percent, and Argentina 1.7 percent) and one of the lowest in the world (the Organisation for Economic Co-operation and Development average is 2 percent of GDP) (ECLAC 2009; OECD 2010). In practical terms, only the Federal District and some big municipalities collect the property tax efficiently, and the vast majority of local governments in the country do not collect it at all. This remains one of the biggest challenges for the Mexican fiscal federalism framework.[6]

For states, the main taxes are the payroll tax[7] and the administration of federal taxes on vehicles and gasoline, from which the states are allowed to keep the revenue. States have other local taxes such as a lodging tax (important in states with high rates of tourism), taxes on the use of old motor vehicles, and taxes on local lotteries and games. However, the revenue collected from these taxes does not represent significant resources. For details on states' local revenues in Mexico, see table 4A.3.

Subnational debt in Mexico is low by all accounts and relative to international standards; the stock of subnational debt in Mexico accounts for 79 percent of annual nonearmarked transfers, or 2.9 percent of GDP. Figure 4.1 shows the stock of debt for subnationals in Mexico in 2011. Although subnational debt as a share of nonearmarked transfers increased from 50.7 percent in 2008 to 79.2 percent in 2011—the debt as share of GDP increased from 1.7 percent in 2008 to 2.9 percent in 2011—subnational debt in Mexico is low when comparing with countries such as Brazil, China, and India.[8]

The debt in figure 4.1 includes all direct liabilities that are incurred by subnationals that are registered with the Federal Ministry of Finance and that were approved by their local legislatures. It does not include

Figure 4.1 Subnational Debt in Mexico, by State, 2011



Source: Ministry of Finance, Mexico.

Note: GDP = gross domestic product. Data include municipal debt.

short-term loans (incurred and paid in full within the fiscal year and used mostly for cash management), or contingent liabilities such as pensions or supplier's credit, both of which can pose risks. If short-term debt is not officially registered as debt, it could potentially be used to finance current expenditures. In addition, short-term debt was exempted from a higher risk rating and the need to establish prudential reserves. Although state retirement plans represent only 2.3 percent of total retirement accounts in the country, there is a risk that they might become unsustainable in the next decade.

There is a great diversity in terms of the structure and financial sustainability of state retirement schemes. A majority of state retirement plans operate as defined benefit plans, which are, in general, unfunded liabilities of state governments. There are no recent studies that estimate the amount of these liabilities. However, according to the conclusions of a meeting of the National Fiscal Convention (Convención Nacional Hacendaria), Hewitt Associates estimated that states' pensions in 1998 accounted for around 25 percent of GDP. Nearly one-third of state retirement plans operate as funded defined benefit plans, but only 7 percent of states have defined contribution schemes based on individual retirement accounts.

As can be seen in figure 4.1, the stock of subnational debt in Mexico is only 79 percent of annual nonearmarked transfers, or 2.9 percent of GDP. At first glance, this low level of debt represents a puzzle from the point of view of economic theory, given the shocks that subnationals faced during the crisis and the need for infrastructure investment.[9] Some observers of the Mexican fiscal federalism framework have concluded that some kind of hidden bailouts must exist in Mexico simultaneously with incentives for subnationals to rent-seek from the federation as an instrument to smooth fiscal shocks and close year-end budgets (see Hernández, Díaz-Cayeros, and Gamboa 2002a, 2002b). These grants would make debt unnecessary as a mechanism to balance the fiscal accounts.

Table 4.2 shows the structure of the stock of subnational debt in Mexico. The total stock of subnational debt is collateralized with federal transfers or with a future flow of local taxes. That is, no lender gives an unsecured loan to a subnational in Mexico. Three-quarters of the total stock of state and municipality debt in Mexico has federal transfers as

Table 4.2 Subnational Debt Structure in Mexico, 2011
billion pesos, and percentage

	Collateral			
Creditor	**Federal transfers[a]**	**Own revenue**	**Total**	**% of GDP**
Commercial banks	186	15	201	1.5
Development banks	86	6	92	0.7
Securitizations	18	40	58	0.4
Trust funds	8	11	19	0.1
Other[b]	19	2	21	0.2
Total	317	74	391	2.9
% of GDP	2.4	0.6	2.9	

Source: Ministry of Finance, Mexico.
Note: GDP = gross domestic product.
a. Includes debt collateralized with nonearmarked transfers (participaciones) and with FAIS and FAFEF, which are earmarked funds (a*portaciones)* that may be collateralized; see table 4A.2.
b. Includes Sofoles (Limited Purpose Financial Institutions), Sofomes (Multiple Purpose Financial Institutions), and suppliers.

collateral. The income pledged is usually the nonearmarked transfers, but some earmarked funds are starting to be used as well.[10] As regards the creditors, private commercial banks hold 51 percent of the debt, government development banks hold 24 percent, and the rest is placements with the markets (mainly bonds or securitized notes). Since 2005, this composition has remained almost unchanged.

In Mexico, the institutional framework for subnational debt starts with the 1917 Constitution, which mandates a "golden rule" for state and municipal debt: all indebtedness must be used to finance "productive public investments." What this means in practice (and whether it includes modern debt operations such as refinancing or debt buybacks) has been the subject of much debate among lawyers, including the Supreme Court, state treasuries, and investment bankers who advise subnationals on the flexibility of the constitutional rule.[11] The Constitution also prohibits states and municipalities from borrowing in foreign currency or from a foreign creditor.[12]

Below the constitutional level, Mexico's subnational debt framework was reformed in 2000. The old framework was based on the concept of the *mandato* (mandates). This meant that the federal government acted as a trustee in servicing state debt that had been collateralized with *participaciones*.[13] What happened in practice was that the *mandato* was perceived by the markets as a guarantee by the federal government on subnational debt. Not surprisingly, as argued in Giugale, Korobow, and Webb (2000), this perception of a federal bailout created two problems: (a) banks had the incentive to make loans, since they perceived them to be risk free; and (b) subnationals also had the expectation of a bailout since it was not credible that the federal government would in fact reduce transfers.[14] To eliminate these problems, several reforms were implemented from 1997 to 2000 (for a detailed account of these reforms, see Guigale, Hernández, and Oliveira [2000]).

The reforms regarding the new regulatory framework for subnational debt, in place since 2000, were based on two main concepts: an explicit renunciation of federal bailouts and a new system aimed toward a correct evaluation by lenders of idiosyncratic subnational risk. These objectives were pursued through (a) the elimination of the *mandatos*; (b) establishment of a link between the capital risk weighting of bank loans to subnationals and their credit rating; (c) and a requirement to register subnational loans with the Ministry of Finance, conditional on being current on fiscal transparency requirements.[15]

Ten years after the establishment of the new regulatory structure, it can be said that Mexico's subnational debt framework is more of a hybrid between a rules-based and a market-based system. Indeed, it can be described as a quasi-market-based system that rests on the following three distinct characteristics.[16]

The first characteristic is the credible threat of no federal bailout. This was accomplished with the elimination of the *mandato* (the instruction that subnationals gave to the federal government to service their debt for them, out of their transfers) and the creation of intercepts (which, in practice, are set up as trust funds established by the subnational and their creditors).

The second characteristic is the increased transparency of the subnational debt market. All collateralized debt must be registered with the Ministry of Finance (conditional on having been approved by the local congress, and the state being up-to-date in transparency requirements). If it is not registered, then the loan is automatically risk weighted by regulators at the penalty rate of 150 percent, which not only raises the cost of the loan directly but also makes the bank credit committees reluctant to lend at all. States have found that there is a strong incentive to register loans that are not legally required to be registered, since this often results in better credit conditions from the lenders. Therefore, the Mexican registry of subnational public debt is quite accurate in listing all outstanding claims.[17] This process has resulted in increased transparency of the Mexican subnational debt market. Thus, the general public and opposition parties have imposed a certain amount of fiscal discipline on local governments with this mechanism.

The third characteristic that defines the regulatory regime is that many of the constraints on the market are the result of the prudential regulation of banks, rather than the result of direct fiscal rules on subnationals.[18] In particular, a capital risk weight is assigned to loans to subnationals depending on the credit rating of the loan. Therefore, the pricing of credit should be a function of the creditworthiness of the state or municipality. Almost all of them now get credit ratings, since not having a credit rating also leads to the penalty capital weighting of 150 percent.[19]

The combination of the described rules and mechanisms implemented in Mexico has ensured an orderly and functional subnational debt market. Notwithstanding the low stock of subnational debt, as in any comparison among Mexican states, there is a wide heterogeneity across states in their indebtedness level, and some states continue to face fiscal adjustment challenges.[20] Nonetheless, the level of subnational debt does not appear to pose a significant systemic or macroeconomic problem.

In fact, the relevant policy question might very well be the opposite: is subnational debt in Mexico suboptimal, given increased needs for development and infrastructure? The answer is beyond the scope of this chapter. However, the low amount of subnational debt in Mexico (as a percentage of GDP) is the second salient fact of its fiscal federalism framework, and frames the policy responses that were taken under the extreme macroeconomic shocks suffered during the 1994–95 Tequila Crisis and more recently with the "great recession" of 2008–09. The different policy responses regarding the safeguarding of the subnational debt market are detailed in the following two sections.

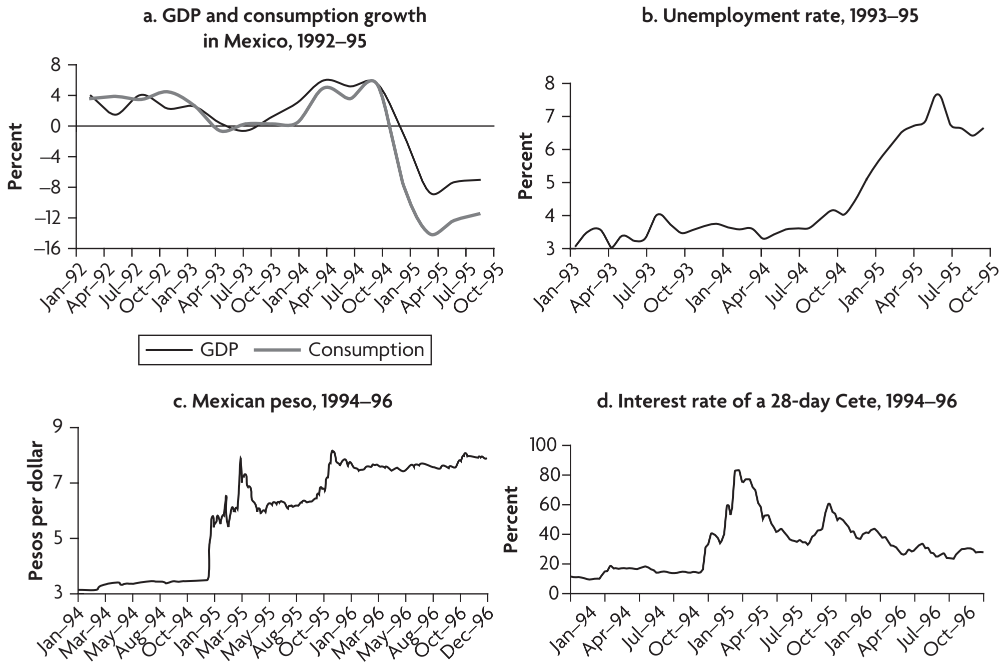
The 1994–95 Tequila Crisis and the Restructuring of Subnational Debt

For Mexico, 1994 was a disastrous year. It included the assassinations of the official party's presidential candidate and of its leader, the rise of an armed insurrection in the southern state of Chiapas, and the continual deterioration of foreign investors' perceptions. With a fixed exchange rate, these events led to a massive run on foreign reserves. On December 19, 1994, Mexico suffered one of its greatest macroeconomic shocks in its history when the fixed exchange rate regime was abandoned. In 1995, the GDP dropped 6.2 percent in real terms compared to the previous year. Inflation reached 52 percent that same year. The Mexican peso lost 49.7 percent of its value in December 1994, and throughout 1995 the currency depreciated an additional 49 percent. The nominal value of the exchange rate, which was 3.4 pesos per dollar at the beginning of December 1994, reached 7.7 pesos per dollar by the end of December 1995. International reserves at the central bank dropped from US$30 billion at the beginning of 1994 to only US$6 billion in December 1994. The impact on interest rates was astounding, as well: interest rates of a one-month Treasury bill reached more than 80 percent during 1995.

The crisis brought painful costs in terms of increased poverty, a costly bank restructuring, and a difficult economic environment for firms and families. It is no surprise that under these conditions, states and municipalities faced dire financial circumstances, and, given that their debt was mostly contracted at a variable rate, their obligations became unsustainable overnight. Figure 4.2 shows the interest rate of a one-month Treasury bill, and the impact of the crisis on GDP and consumption, employment, and the exchange rate.

Subnationals faced two main direct shocks that made them unable to service their debts. First, the extraordinary rise in interest rates made their debt untenable, since most of it was contracted at variable rates. Second, given that the main source of income was the *participaciones* (which fluctuate with the federal taxes that are shared), the impact of the crisis on federal revenue implied that in 1995, federal nonearmarked transfers were 22 percent lower in real terms than in 1994. With lower income sources and higher interest payments, the specter

Figure 4.2 The Macroeconomic Impact of the 1994–95 Tequila Crisis in Mexico



Source: Banco de México.

Note: GDP = gross domestic product. A *Cete* is a credit title issued by the federal government.

of default loomed larger. In this context, the federal government intervened to engineer an important restructuring process that was based on the following four main pillars. The following series of interventions did not occur as a single event, but were spread over the recovery period of the crisis.

First, the federal program included a direct restructuring mechanism. In this way, the federal government, through the Ministry of Finance, restructured around 90 percent of the outstanding subnational debt (in an amount equivalent to US$8 billion at 2009 prices). The restructuring lowered the interest rate to a fixed 10.5 percent nominal rate and increased the maturity from an average of 6.6 years (see Fedelino and Ter-Minassian 2010) to 15 and 20 years. It was structured by Banobras, the federal government's development bank that lends to subnational governments.

Second, to help states deal with the decrease in federal transfers (*participaciones*) caused by the lower federal collection of shared taxes, the federal government gave an extraordinary transfer to all states in 1995 and 1996 of approximately US$1 billion (2009 prices) for each year, equivalent to 10 percent of annual transfers.

Third, the federal government, again through Banobras, engineered an extraordinary loan for states collateralized with nonearmarked transfers. The loan was equivalent to US$500 million (2009 prices) or 5 percent of annual transfers. It would be paid out of one-year transfers and at the federal government's cost of financing.

Fourth, the federal government resorted to extraordinary discretional transfers to some states that were negotiated independently and usually not reported. By definition, this "hidden bailout" is difficult to quantify because there are no data and it does not appear in traditional accounting or reports of subnationals. However, Hernández, Díaz-Cayeros, and Gamboa (2002b) try to quantify these "secret" transfers[21] using reductions in debt stocks that are unmatched by state government surpluses, and differences in interest rates before and after debt renegotiations, since interest rates negotiated after the crisis varied among states. Hernández, Díaz-Cayeros, and Gamboa also argue that some of the new credit obtained via official development banks was used for current expenditures and not investment (as the law mandates), which would amount to an indirect bailout. Finally, when considering the determinants of these hidden bailouts, they find that the size of the bailout was related to the size of the state and to the previous level of fiscal indiscipline (with states that had bigger deficits getting more support), but not to political variables.

The bailout worked in preventing the meltdown of subnational debt markets, thus preserving the functioning of local governments and service delivery. In studying the consequences of the bailout (both the open and hidden parts), Hernández, Díaz-Cayeros, and Gamboa (2002b) find two important consequences. First, there were distributional effects, with higher per capita extraordinary transfers given to states with higher per capita GDP. Hence, poorer states (less indebted) received less in extraordinary support. Second, as with any bailout, some moral hazard problems were created, since the bailout did not resolve structural fiscal imbalances. It consisted basically of a one-year relief program. After the crisis, subnational governments kept incurring deficits because they anticipated they would be bailed out again.

These special bailouts came from a large discretionary account for the presidency, which had traditionally been in the budget. After the ruling party lost control of Congress in 1997, however, this practice stopped, and that contributed to the decision to move to the hybrid rules- and market-based system described earlier.

The "Great Recession" of 2008–09 and Subnational Debt in Mexico

As in most countries, the global crisis of 2008–09 caused deep macroeconomic management problems for Mexico. The impact was severe: growth slowed to a painful minus 6.1 percent in 2009, and the public finances of all levels of government suffered accordingly. However, a few things had changed since the Tequila Crisis. One decade of sound macroeconomic management that achieved much needed fiscal and monetary space, combined with a different transmission channel and the external origin of the crisis, produced a very different effect on the subnational debt market. Table 4.3 summarizes the similarities and differences of both crises.

What was fundamentally different in the 2008–09 crisis for subnationals was the absence of an interest rate shock. The one-month

Table 4.3 Two Crises: Implications for the Subnational Debt Market in Mexico

	Tequila Crisis, 1995	Global financial crisis, 2008–09
Origin	Domestic	Foreign
Cause	Reversion of large capital inflows together with some financial vulnerabilities: • Semifixed exchange rate • Large current account deficit resulting from a huge credit expansion • Substantial rise in interest rates in the United States • Accumulated political tensions during 1994[a]	• Global asset price bubbles and low interest rates • Subprime mortgage crisis in the United States • Excessive leveraging leading to serial defaults • Weak regulation of financial markets
Macroeconomic impact for Mexico	• Currency depreciation of 117 percent[b] • GDP dropped 6.2 percent in real terms • Inflation exceeded 50 percent • *Interest rates reaching 80 percent*[c]	• Currency depreciation of 49 percent[d] • GDP dropped 6.1 percent in real terms • Inflation of 4 percent • *Interest rate fluctuations between 4 and 8 percent*[c]
Impact on Mexican credit markets	• Complete dry-up of local credit • Banking crisis	• Dry-up of foreign credit, but less impact on local credit markets since local banks remained strong throughout the crisis
Impact on subnational credit markets	• Severe dislocation • States unable to repay debt service because of: ◦ Higher interest payments ◦ Less capacity for repayment, as revenues dropped	• Significant effort to contain the impact • States suffered only through a lower capacity to service payments, but Rainy Day Funds were used to smooth the shock.

Note: GDP = gross domestic product.

a. Gil-Díaz 1998.

b. From December 1994 to December 1995.

c. Rate on one-month Treasury bill.

d. Maximum depreciation during 2009. However, the Mexican peso recovered part of its value throughout 2009.

Treasury bill fluctuated from 4 to 8 percent from 2008 to 2010. This is in contrast to what happened during the Tequila Crisis, when the rate increased from 10 percent at the beginning of 1994 to above 80 percent by the first quarter of 1995. This meant that there was no immediate increase in the cost of servicing the debt for states and municipalities. The shock, however, came through a different set of channels that affected the revenue of subnational governments and, hence, the possibility of servicing that debt.

First, a dramatic decrease in the price of oil meant significantly lower oil revenues, which are shared among levels of government.[22] In 2009, federal government oil revenue dropped 32 percent in real terms. Second, the slowdown of economic activity implied a significant reduction in federal tax revenue, which is also shared. Federal nonoil tax revenue during 2009 decreased 10.5 percent in real terms. The combined impact of these shocks on federal revenue meant significantly reduced transfers for subnationals. Without the use of Rainy Day Funds (RDFs) (see discussion below), transfers in 2009 would have decreased 15 percent in real terms. Given their almost complete dependence on federal resources, this implied a momentous reduction in their capacity to service their debt and finance government operations. In the absence of federal intervention, many states would have defaulted on their debt. Figure 4.3 shows the deterioration in subnational credit ratings, and therefore on credit conditions, during the crisis.[23]

Under this scenario, the federal government could have provided a direct bailout of the states via extraordinary transfers or a combination of the mechanisms discussed in the previous section, or it could have forced or been instrumental in a system-wide restructuring of subnational debt. The solution, however, came from a different and innovative mechanism: the coordinated sale of future federal surplus revenues that belong to the states.

The coordinated, collective mechanism has been developed to smooth the shock on local public finance. The Mexican macroeconomic management framework was significantly improved in 2005 with the approval of a Federal Fiscal Responsibility Law. Among other things, the law mandated a balanced federal government budget and created RDFs for the federation and for subnationals. The funding of the RDFs was through annual federal surplus revenue (both oil

Figure 4.3 Deteriorating Subnational Credit Scores in Mexico during the Global Financial Crisis

Number of increases in subnational ratings minus decreases

Sources: Fitch Ratings; Standard & Poor's.
Note: Increases in graph (+1 for each positive change in rating), decreases (-1 for each negative change in rating), changes in economic outlook (+/-0.25).

and federal tax) when, in any given year, receipts exceed the program. Although the size of the funds in terms of GDP was small (reaching 0.7 percent of GDP for the federal RDF, and 0.2 percent of GDP for the subnational RDF), by 2008 the federal fund had accumulated 86 billion pesos and the subnational fund—the Fund for the Stabilization of the Federal Revenue for the Federal Entities (Fondo de Estabilización de los Ingresos de las Entidades Federativas, FEIEF)—had accumulated 25 billion pesos.[24] The funds were designed to be used to smooth out temporary decreases in federal revenues, which was the case in 2009.

To understand the size of the macroeconomic shock for Mexico caused by the global crisis, consider the difference between expectations for 2009, formed in the fall of 2008, as reflected in the macroeconomic forecasts included in the budget, and the observed data for the close of that fiscal year. The federal budget for 2009 included both a real GDP growth forecast of 1.8 percent and an average price of oil of US$70 per barrel for the year. When 2009 ended, growth was a full 6 percentage points lower, while the price of oil averaged US$53 per barrel. This implied a gap of 480 billion pesos in the federal government balance,[25] and a reduction in federal nonearmarked transfers for subnationals of 70 billion pesos (or 15 percent) relative to the budget. In the absence of a smoothing mechanism, chaos would have ensured for states and municipalities. As in other parts of the world,[26] services would have to be cut dramatically; taxes raised; subnational workers would have been laid off, with the associated political cost; and defaults would have been inevitable.

The first line of defense to smooth the decrease in federal transfers and prevent problems in the subnational debt market was to use savings in the state's RDF, the above-mentioned FEIEF. Soon it became clear that the entire available balance in the fund (25 billion pesos) would not be enough to cover the expected decrease in transfers for that year (a gap of 70 billion pesos between state aggregate budget transfers and expected transfers was projected by June 2009). The federal government, under pressure from states and municipalities, and under financial stress of its own, was considering more traditional avenues for restructuring subnational obligations as described in the previous section, to close the projected gap: a generalized extraordinary transfer, a restructuring of subnational debt to lower payments, and giving much needed space to local treasuries, or a direct loan to states. They all had their drawbacks.

An extraordinary transfer would put additional pressure on the federal government's finances, and would completely shift the cost of the crisis onto the federation. A restructuring of subnational debt would have been difficult to achieve given the decentralized nature of the market, the heterogeneity of lenders, and the diverse exposure of states. A direct loan by the federation to subnationals had the disadvantage that the federal government would have to put the asset on its books at a time when its fiscal position was weak—in relative terms—and the loan would have had to be standard in the sense that each state would have had to get local legislative approval (a difficult process that was complicated by federal and local politics and slow and difficult timing, and would not have been successful because some states were already at their locally established debt limit[27]). Also, the proceeds from the financing would have had to conform to the constitutional golden rule and be used for infrastructure.[28]

Instead of using one of the traditional avenues for restructuring, the federal government, together with the states, engineered an innovative mechanism that satisfied the following criteria: (a) involvement of the subnationals' own balance sheets in the smoothing of shocks;[29] (b) giving subnationals a direct substitute of nonearmarked transfers;[30] and (c) making it fast, credible, and efficient. The process was as follows: the federal government used its coordination powers to harmonize the needs of all subnationals for additional financing and put them on a path to access the market collectively at a low cost of finance. The specific mechanism used was the leveraging of the RDF for states, that is, the FEIEF.

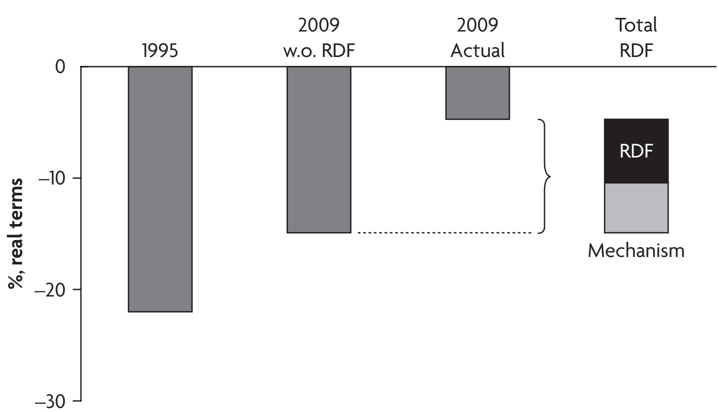
Since the FEIEF belongs to the states, and is funded by a future flow of income (the sequence of future annual excess surplus that corresponds to subnationals), it was an effective vehicle to bring to present value future resources. Essentially, the correct response to a transitory fiscal gap is to use debt financing to avoid increasing taxes or reducing expenditure.[31] However, no state by itself would have had access to the markets, or would have done so at high prices, given the deterioration of liquidity in the credit markets at the time. The federal government coordinated the states—and municipalities—to agree to the selling of future flows of their RDF for a present value amount to be received and used as nonearmarked transfers in 2009.

States and municipalities, through the Mexican National Association of State's Secretaries of Treasury,[32] (Comisión Permanente de Funcionarios Fiscales) orchestrated the operation with the advice and coordination assistance of the federal government. The whole structuring process, from initial design to its closing, took four months. Subnationals obtained 40 billion pesos in the market[33] (equivalent to 10 percent of annual nonearmarked transfers), to be paid back in 13 years (or sooner if the future flows toward the RDF are larger than expected) at a cost of financing similar to that of the federation—and about 200 basis points lower than the average cost of finance for subnationals in Mexico.[34] This substantial amount of resources almost completely closed the gap in nonearmarked transfers, bringing it to minus 2.2 percent (compared to the budget forecast), an astoundingly small shortfall given the worst crisis since the Great Depression in the 1930s. In fact, the federal government had a substantially bigger fiscal gap to close that year, and for all practical purposes, the Mexican subnationals did not suffer the impact of the global crisis in their finances. Debt continued to be served on time, and there was no dislocation in the subnational credit market.

Figure 4.4 compares the fall in nonearmarked transfers in each of the crises. Whereas the Tequila Crisis reduced nonearmarked transfers by 22 percent relative to the previous year (and hence the restructuring program described in the previous section was implemented), the global crisis, in the absence of policy intervention, would have reduced transfers by 15 percent in 2009 relative to 2008. However, with the mechanism described (using the subnational RDF, current and future), transfers were reduced only 5 percent in real terms relative to 2008. This shock was then easily absorbed by subnational governments.

Figure 4.5 shows the evolution of the expectations of the end-of-year gap between observed transfers and the budget forecast, during 2009. Each point on the lines represents the expected gap for 2009 as of the month indicated. The lower line represents the gap without the use of the RDF, and the upper line represents the expected gap with the innovative use of the RDF. Several conclusions can be drawn.

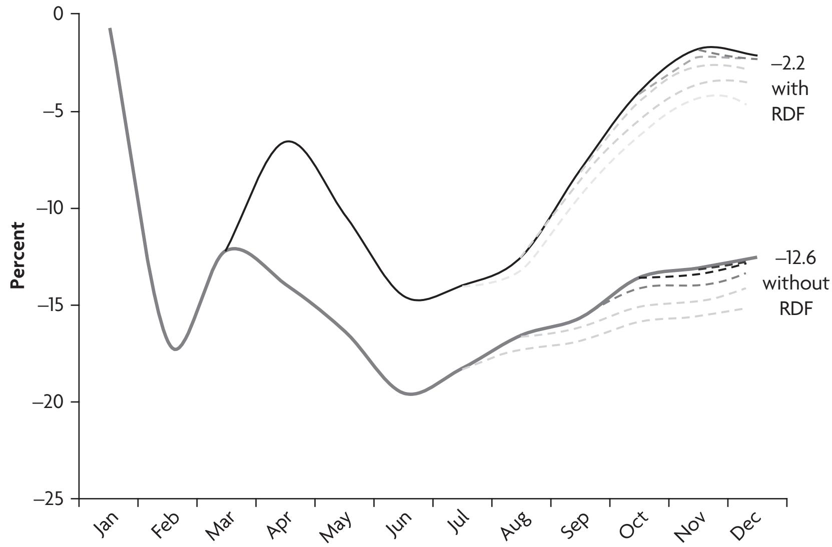
Figure 4.4 Fall in Transfers Relative to Previous Year in Mexico during the 1994–95 Tequila Crisis and the 2008–09 Global Financial Crisis



Source: Ministry of Finance, Mexico.
Note: w.o. RDF = without Rainy Day Fund.

Figure 4.5 Federal Transfers: Evolution of Expectations in Mexico during the Global Financial Crisis, 2009

Expectation of end-of-year gap, formed in each month



Source: Ministry of Finance, Mexico.
Note: RDF = Rainy Day Fund.

First, one can see the evolution of the crisis and how it was worsening during the first half of the year. At its worst point (June 2009), nonearmarked transfers were expected to be 20 percent lower than what was forecasted in the budget. This would have been a substantial blow to subnational governments. Second, in the last half of 2009, there was a slight recovery in the economy, which was reflected in improved expectations; but still, without the RDF transfers, it would have been 12.6 percent lower than budgeted. Third, as mentioned, the RDF operation almost closed the gap completely and, by the end of the year, transfers were only 2.2 percent lower than budgeted.

After the operation, subnational debt markets continued functioning normally and debt continued to be serviced. As the recovery occurred, credit conditions gradually improved, beginning in the second quarter of 2010 (see figure 4.3 earlier). The innovative use of credit markets and the involvement of the subnational governments' own balance sheets in the debt management have contributed to preserving the health and stability of the subnational debt markets. The stability of the subnational debt markets has also been helped by the improved macroeconomic management in the country prior to the crisis and the turnaround economic growth. In 2010 and 2011, the Mexican economy grew at 5.4 and 3.9 percent, respectively.

Lessons and Conclusions

Subnational debt markets perform essential functions, expanding the resources of local governments to finance infrastructure and facilitating the transfer of resources across time to smooth out transitional fiscal shocks. They also pose risks, particularly if the central government has to bail out local governments in times of stress.

In reality, however, all debt markets will fail from time to time. That is why a well-structured regulatory framework needs to take into consideration both the ex-ante rules for getting into debt, and the ex-post mechanisms to deal with insolvency and restructuring. Governments will deal with crises constrained by the mechanisms in place, the nature of the crisis, and the tools available at the time. Learning from other times and places is of value to add to the toolkit of policy makers, improve the current set of institutions, and prevent further dislocation in markets.

Mexico experienced two major macroeconomic crises in the last two decades, both of which had important bearings on the subnational debt market. While the two episodes affected local governments substantially, the policy responses were markedly different and therefore had distinct consequences. This chapter explored Mexico's approach to subnational debt management in each of those crises.

One of the main lessons of the 1995 experience is that if a bailout of subnational governments is necessary, it should not be addressed exclusively to closing the year-over-year deficits in primary balance. Instead, the main focus should be solving the structural fiscal imbalances of states. This means that the expenditure path must be determined by the expected flow of future income. The federal government should condition the extraordinary transfers to certain results, such as reducing unnecessary expenses (a "structural adjustment" strategy).

The global crisis introduced a different set of challenges to ensuring the orderly functioning of the subnational credit market. In this case, since interest rates remained low, the channel affecting subnational finances was in their repayment capacity because of the lower resources that states and municipalities had available in 2009. In this case, the federal government did not resort to a traditional bailout or to extraordinary transfers, but used its coordinator function to achieve a more efficient outcome: the subnational governments got directly involved to bring to present value the future flow of revenue of their RDF. This innovative mechanism ensured that states' own balance sheets were used to smooth the fiscal shock. Also, the use of the (present and future) RDF implied that subnational governments in Mexico did not suffer significant fiscal consequences from the global crisis. Given the fiscal consequences on governments around the world, of economies advanced and developing, this is remarkable. Nonetheless, the uncertainty of the global recovery poses challenges to macroeconomic management, including the management of public finance at both the federal and subnational levels.

The desired level of RDFs is a complex subject. A range of factors influence the level, including macroeconomic and market conditions, fiscal policy objectives, and the size and duration of macroeconomic shocks. In the case of Mexico, the success of leveraging the RDF might imply a lower optimal long-run level of RDFs—since one could bring to present value future flows of the fund. (The large RDFs might become a temptation for politicians to spend.) However, one would be averse to having to depend on access to markets *specifically* at the time when one is experiencing a fiscal shock. Mexico had a solid fiscal position coming into the crisis, and hence had extraordinary access to markets even in the downturn (consider also the path of interest rates and access to credit for the 2008–09 global crisis, shown in table 4.3). But crises come in different shapes and have different transmission channels, so this might imply a larger optimal long-run level of RDFs. Hopefully, the Mexican experience contributes to the larger debate on the optimal size of stabilization funds.

Another important lesson is the consideration of the relative benefits of a rules-based mechanism for subnational debt regulation compared to a market-based mechanism. Mexico has evolved into a hybrid, quasi-regulated market system. In this regulatory framework, the major ingredients are the federal threat of no bailout, the transparency of markets and, more important, the regulation of the market via the prudential regulation of banks. This appears to have worked. Subnational debt, at its low levels, does not appear to pose a macroeconomic or systemic threat. Indeed, it is the fact that it has a relatively low value (at 2.9 percent of GDP) that is surprising, given the infrastructure needs of subnationals in Mexico.

A country's macroeconomic framework has an important bearing on its subnational debt markets. The important elements of the macroeconomic management framework for the health and evolution of subnational debt markets are (a) the fiscal position and debt stock of the federal government, (b) the currency regime, (c) monetary policy, and (d) economic growth. Future challenges for Mexico include translating the success of macroeconomic management at the federal level to create a more dynamic and transparent subnational debt market that contributes more effectively to the financing of infrastructure at the local level and, hence, to the economic growth and development of the country.

Annex

Table 4A.1 "Ramo 28." Nonearmarked Transfers (Participaciones Federales), Mexico

Fund	Purpose	Funding	Distribution criteria	Destination	Share of total[a] (%)
FGP	Revenue sharing with states and municipalities	20 percent of RFP[b]	State GDP growth; local revenue (level and growth)	State and municipal[c]	86
FFM	Revenue sharing with municipalities	1 percent of RFP[b]	Municipal revenue (water and property tax)	Municipal	4
FOFIE	Incentive for enforcement of tax laws	1.25 percent of RFP[b]	Measures of local effort of enforcement of tax law	State and municipal[c]	5
3.17 percent[d]	Resources for oil-producing municipalities	3.17 percent of a special oil royalty	Municipal revenue (water and property tax)	Municipal	0.3
0.136 percent[e]	Resources for borderline municipalities	0.136 percent of RFP[b]	Municipal revenue (water and property tax)	Municipal	0.7
FEXHI	Compensate for oil and gas extraction	0.6 percent of main oil royalty	Oil and gas production	State and municipal[c]	1
IEPS	"Sin tax" revenue sharing with states and municipalities	8 percent of tobacco; 20 percent of beer and alcohol	Local consumption of those goods	State and municipal[c]	2
FOCO	Compensate the 10 poorest states	2/11 of local gasoline tax collection	Inverse of nonoil GDP per capita	State and municipal[c]	1

Source: Ministry of Finance, Mexico.

Note: FGP = General Participation Fund (*Fondo General de Participaciones*), FFM = Fund for Municipal Aid (*Fondo de Fomento Municipal*), FOFIE = Tax Enforcement Fund (*Fondo de Fiscalización*), FEXHI = Fund for Oil Extraction (*Fondo de Extracción de Hidrocarburos*), GDP = gross domestic product, IEPS = "Sin Tax" Revenue Sharing (*Impuesto Especial sobre la Producción y Servicios*), FOCO = Compensation Fund (*Fondo de Compensación*).

a. Shares calculated based on data for 2010.

b. Shared Federal Revenue (*Recaudación Federal Participable*, RFP): The pool of federal revenues that is shared with states and municipalities includes the income tax, the value-added tax, all other federal taxes, and oil revenues. It does not include revenue from public enterprises, federal government financing, or certain other sources of nontax revenue.

c. States are required by law to share at least 20 percent of these resources with municipalities.

d. 3.17 percent of special oil royalty (*3.17 percent del Derecho Adicional*).

e. 0.136 percent of RFP (*0.136 percent de la RFP*).

Table 4A.2 "Ramo 33." Earmarked Transfers (Aportaciones Federales), Mexico

	Purpose	Funding	Distribution criteria	Destination	Share of total[a] (%)
FAEB	Elementary education	Theoretically, enough money to cover payroll[c]	Student enrollment and state spending on education	State	59
FASSA	Health services	Theoretically, enough money to cover payroll[c]	Health indicators; number of health workers	State	12
FAIS	Social and rural infrastructure	0.303 percent of RFP[b]	Poverty index	State	9
		2.197 percent of RFP[b]		Municipal	
FORTAMUNDF	Municipal strengthening	2.35 percent of RFP[b]	Population	Municipal	9
FASP	Public security	Budget negotiation process	Population; delinquency and criminality indexes	State	2
FAETA	Promote adult education and literacy	Theoretically, enough money to cover payroll	Schooling and workers	State	1
FAM	Social assistance and education infrastructure	0.814 percent of RFP[b]	Social vulnerability index	State	3
FAFEF	Financial needs and pensions	1.4 percent of RFP[b]	Inverse of GDP per capita	State	5

Source: Ministry of Finance, Mexico.

Note: FAEB = Fund for Elementary Education (*Fondo de Aportaciones para la Educación Básica*), FASSA = Fund for Health Services (*Fondo de Aportaciones para los Servicios de Salud*), FAIS = Fund for Social Infrastructure (*Fondo de Aportaciones para Infraestructura Social*), FORTAMUNDF = Fund for Municipal Strengthening (*Fondo para el Fortalecimiento Municipal y de las Demarcaciones Territoriales del D.F.*), FASP = Fund for Public Security (*Fondo de Aportaciones para la Seguridad Pública*), FAETA = Fund for Adult Education (*Fondo de Aportaciones para la Educación Tecnológica y de Adultos*), FAM = Fund for Social Assistance (*Fondo de Aportaciones Múltiples*), FAFEF = Fund for State Strengthening (*Fondo de Aportaciones para el Fortalecimiento de las Entidades Federativas*), GDP = gross domestic product.

a. Shares calculated based on 2010 data.

b. Shared Federal Revenue (*Recaudación Federal Participable*, RFP): The pool of federal revenues that is shared with states and municipalities includes the income tax, the value-added tax, all other federal taxes, and oil revenues.

c. These funds were created to cover states' education and health payrolls after the decentralization of these sectors in the 1990s. The size of these funds has usually been determined by political forces during the federal budget negotiation process, and almost all states argue that the resources they receive from these funds are insufficient to fully cover their payroll.

Table 4A.3 Mexican States' Total Local Revenue: Own-Source and Coordinated Federal Taxes[a]
million pesos

	2005	2006	2007	2008	2009	2010
Total local revenue	106,762	124,420	138,213	160,687	165,433	184,338
Own revenue	81,894	92,892	103,262	119,667	115,552	132,829
Taxes	34,818	39,160	44,396	47,864	49,417	57,706
Payroll	20,178	23,276	27,567	30,227	31,523	36,466
Other taxes	4,761	6,065	6,729	7,113	7,851	9,684
Use of motor vehicles (> 10 years)	721	1,295	1,299	1,360	1,344	1,361
Lodging	788	866	1,054	1,104	1,110	1,337
Personal property	992	1,170	1,275	1,299	1,267	1,235
Other[b]	2,259	2,734	3,101	3,350	4,130	5,752
Property tax and property sales tax[c]	9,879	9,818	10,100	10,523	10,042	11,556
Nontax revenue[d]	47,075	53,732	58,865	71,803	66,135	75,123
Coordinated federal taxes[a]	24,868	31,528	34,952	41,020	49,881	51,509
Vehicle-related taxes	20,873	23,989	25,827	26,175	24,515	23,773
Federal tax on use of motor vehicles	15,262	18,814	20,245	21,100	20,448	19,093
Tax on new vehicles	5,611	5,175	5,582	5,075	4,067	4,680
Fuel tax	—	—	—	5,080	15,334	17,482
Other coordinated federal taxes[e]	3,995	7,539	9,125	9,765	10,032	10,254

Sources: Ministry of Finance, Mexico; states' public accounts.
Note: — = not available.
a. "Coordinated federal taxes" are federal taxes (the base and rate are defined by the federal government) administered and fully collected by state governments. In that sense, they behave (and are sometimes considered as) local revenue.
b. Includes taxes on lotteries and games, special profession taxes, state tax on use of motor vehicles, etc.
c. Considers the revenue from the property tax and the property sales tax in the Federal District, where these taxes are collected at the state level. For the rest of the states, they are collected at the municipal level.
d. Alcohol, drivers', and other licenses; received; state-owned enterprises; fines and charges; and other.
e. Federal income tax and value-added tax for low-income firms, federal taxes in coastline areas, special fund for the tax on new vehicles.

Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

1. There are 2,440 municipalities in Mexico, with a wide heterogeneity in size and level of development. Population ranges from 1.8 million in the largest municipality (about the size of Phoenix, Arizona) to only 102 in the smallest. The most developed municipality in Mexico has a Human Development Index close to that of Portugal, while the least developed can be compared to Sierra Leona. Municipal budgets range from 4.2 million pesos to 4.1 billion pesos, a ratio of 1:1,000.
2. This "third channel" consists mainly of a set of new special-purpose funds that are mostly earmarked for infrastructure. The growth of this channel can be seen in "Ramo 23" of the federal budget: in 2007 it amounted to 10.5 billion pesos, while for 2012 it is budgeted at 30.6 billion pesos (an increase of 134 percent in real terms). Examples of funds included are the "regional fund" (for 10 states); the new "metropolitan funds," which currently distribute resources to 46 metropolitan areas; and other funds for specific purposes such as natural disasters, aid to migrant workers, and for paving municipalities.
3. The pool of federal revenues that is shared with states and municipalities includes the income tax, the value-added tax, all other federal taxes, and oil revenues. It does not include revenue from public enterprises, federal government financing, or certain other sources of nontax revenue.
4. The formula was reformed in 2007 from an old formula that caused wide distortions in Mexico's fiscal federalism. For a detailed description of the distribution formula and its reform, see Revilla (2012).
5. "Ramo 33" refers to line item 33.
6. Efforts have been made since 2007 to give incentives to subnationals to increase own-source revenues. The most important was the reform of the formula for nonearmarked transfers, which started being used in 2008. The new formula is designed to substantially increase the incentives for states and municipalities to increase their own revenue. After only four years (and considering that the new formula provides for a gradual transition, since it was designed with a generous hold-harmless clause), it can be seen that subnationals are greatly increasing their local tax efforts.
7. The subnational payroll tax is collected on the payrolls of businesses that operate within state lines, at a rate that is freely set by the state legislature. All states collect the tax now at a rate that fluctuated between 1 and 3 percent in 2011.
8. See chapter 1 on Brazil, chapter 10 on China, and chapter 3 on India in this volume.
9. According to the Global Competitiveness Report published by the World Economic Forum (2006), Mexico's "infrastructure competitiveness" is ranked 64th among countries. Its performance stands below the world average and below the average for Latin America. Mexico's investment in infrastructure accounts

for only 3.2 percent of GDP, and compares poorly to the investment of countries like Chile (5.8 percent of GDP) and China (7.3 percent of GDP).

10. Particularly from the Fund for Social Infrastructure (*Fondo de Aportaciones para Infraestructura Social*) and the Fund for State Strengthening (*Fondo de Aportaciones para el Fortalecimiento de las Entidades Federativas*). Of the total 206 billion pesos collateralized with transfers, only 5 billion (2.3 percent) pesos are collateralized with earmarked transfers.
11. See Fitch Ratings (2011); Mexican Congressional Budget Office (Centro de Estudios de Finanzas Públicas) (CEFP 2009); and Velázquez (2005) and references contained therein.
12. If a state borrows from an international financial institution, the credit must be channeled through federal government development banks first (so that the forex risk is borne by the federal government and the state does not have any direct obligation to a foreign entity).
13. In theory, the federal government could deduct subnationals' debt service payments from the transfers to the states.
14. Especially because most of the *participaciones* are used for current expenditure, so a reduction in them would leave a state unable to operate and provide basic services.
15. The relevant laws and regulations are the Fiscal Coordination Law (Ley de Coordinación Fiscal), the Public Debt Law (Ley de Deuda Pública), and the Regulation of Article 9 of the Fiscal Coordination Law.
16. The author is indebted to discussions with Emilio Pineda for this interpretation.
17. The registered debt, as mentioned elsewhere in this chapter, includes all explicit loans obtained by subnationals from private commercial banks, government development banks, and the market that were approved by local legislatures. It does not contain contingent (implicit) liabilities, such as pensions, or unsecure short-term loans used for cash management. The registered debt can be accessed online at http://www.hacienda.gob.mx/Estados/Paginas/Deuda.aspx.
18. Subnational fiscal rules for the case of Mexico have the added disadvantage that the accounting practices of local governments are widely heterogeneous and, in some cases, deeply flawed. There is an accounting harmonization process that was set up in 2008 with a constitutional reform that will modernize accounting procedures at all levels of government. As of 2012, states have progressed slowly toward accounting harmonization.
19. These banking regulations were put in place in 1999–2000, as part of the prior actions for the 1999 Decentralization Adjustment Loan from the World Bank. They had to be done through financial sector regulation, over which the federal government has authority, because constitutionally the federal government could not impose such rules directly on the states.
20. In 2011, it was revealed that Coahuila, a northern state, falsified documents to hide the true size of its debt. In reality, in the previous two years it had accumulated a debt of $35 billion pesos (295 percent of its annual nonearmarked

transfers, or 9 percent of its GDP), while reporting only $7 billion pesos. While this case highlights the need to strengthen the transparency of subnational financial reporting, it does not change the overall view of the Mexican subnational debt market as one of low indebtedness without significant systemic risks.

21. In some cases, the extraordinary support could have taken the form of a direct transfer, a renegotiation of debt with a federal development bank (including a reduction in interest and principal or the outright forgiveness of the debt), or support through a budgetary mechanism (for example, reducing the share of subnational expenditure in projects that combine federal and local resources, that is, a reduction in the pari passu of programs, and so forth).
22. The price of Mexican oil suffered a dramatic fall as the crisis hit financial markets, dropping from a maximum of US$130 per barrel in July 2008 to a minimum of US$28 per barrel in December of the same year. Data source: Bloomberg.
23. As in any subnational debt market, there is the question of whether credit ratings truly reflect state's idiosyncratic credit risks (and these, in turn, fiscal risks). While a detailed analysis of the informational content of subnational credit ratings in Mexico is beyond the scope of this chapter, we consider the observed ratings as a good approximation of the credit quality of subnationals at a given moment in time.
24. Total funds amounted to US$8.4 billion, at the exchange rate for December 31, 2008, of 13.82 pesos per dollar.
25. This gap for the federal government was finally closed with the use of the federal RDF, with additional debt, a cut in expenditure, and nonrecurrent revenues.
26. "In the United States the estimated collective gap between states' income and obligations for 2011 will be $55 billion dollars. This means that more than 30 states are projecting a 2011 shortfall of 10 percent or more as a percentage of this year's budget. Many states have already used a big proportion of their RDFs: according to the same report, 14 states are expected to have reserves of less than 1 percent of their annual spending. In order to close the budget gap, states in the U.S. are supposed to make serious expenditure cuts, which might be a difficult job given the upward pressures arising from certain areas, particularly Medicaid" ("The Other Financial Crisis," *Time*, 175 (25), June 28, 2010).
27. For example, the debt of the State of Mexico and the Federal District is at the higher boundary, so there was no space for additional financing.
28. Which, given the fungibility of money, would not have been a problem for those states with significant investment programs. However, some states would not have had space to use it otherwise.
29. In the sense of imposing, or making credible, a hard budget constraint on states.
30. This criterion gives economic efficiency to the restructuring process. Since nonearmarked transfers are the freest form of financing for subnationals, they would use the proceeds to finance their own budgetary priorities during the crisis, as defined by their own legislature process.

31. Provided, of course, that the transitory fiscal gap does not materially reduce the present value of receipts.
32. This is the main representative body in the Mexican national fiscal federalism system. It consists of eight states' ministers of finance who represent the 32. It has powers to decide, as representative of the states, and it coordinates with the federation all relevant topics of fiscal federalism in the country.
33. Given that (according to the Federal Fiscal Responsibility Law) FEIEF is to be used as a perfect substitute of nonearmarked transfers, the funds obtained from the operation had the same nature: they could—and were—used legally as nonearmarked transfers (and not for infrastructure).
34. The loan was paid in full in only two years—by mid-2011 (11 years ahead of schedule)—because of the favorable evolution of oil prices, which increased the repayment capacity of subnationals.

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Part 2

Subnational Insolvency Framework

5

Colombia: Subnational Insolvency Framework

Azul del Villar, Lili Liu, Edgardo Mosqueira, Juan Pedro Schmid, and Steven B. Webb

Introduction

The fiscal and debt stress of Colombia's subnational governments (SNGs) in the late 1990s and early 2000s, exacerbated by the economic downturn, led to substantial public finance reform. Addressing the insolvency of some SNGs was essential to this reform process. Colombia has several laws, mostly enacted between 1998 and 2003, that regulate the origination of debt by SNGs, encourage fiscal responsibility, and provide for central government assistance in rescheduling subnational debt when that becomes necessary. One law—Law 550 (1999)—deals explicitly with bankruptcy proceedings for SNGs.

Although it was traditionally a centralist country, Colombia has become the most decentralized unitary republic in Latin America through a process that started in the early 1970s and accelerated in the 1990s. By the mid-1990s, a number of shortcomings in the decentralization framework had become evident. Besides the absence of fiscal responsibility institutions in these years to control subnational indebtedness, intergovernmental fiscal relations also suffered from a lack of institutions to ensure adequate allocation and use of transfers and to motivate SNGs to generate own revenues and provide required matching funds.

During 1997–2003, the Colombian government passed several laws to discourage excess spending and borrowing. In 1999, it passed the first bankruptcy law (Law 550) in the country, which focused primarily on private, public, and mixed-ownership corporations, but Law 550 also included provisions under Chapter V for bankruptcy procedures of highly indebted SNGs. In 2000, Law 617 modified some features in the application of Law 550, addressing SNGs and decentralized services entities (not covered by a sector-specific superintendency). Regulation (*Reglamento*) 1248 in 2001 also clarified debt restructuring and central government guarantees.

This chapter concerns Colombia's bankruptcy or insolvency framework—its provisions and the actual experience of its implementation in the broader context of reforms to strengthen subnational fiscal discipline in the country.

Most of the bankruptcy procedures were initiated in the early 2000s, to deal with subnational debt problems accumulated during the 1990s, which were further compounded by the general fiscal and economic crisis in the country from the late 1990s to early 2000s. The development and implementation of the bankruptcy proceedings were helped by enactment of several other fiscal reform laws (1998–2003) that encouraged subnational fiscal responsibility and discipline. Strong economic growth after 2003 also helped the fiscal position of governments at all levels.

The Colombian bankruptcy procedures for SNGs differ from those in countries such as Hungary and the United States. The procedures in Colombia are administrative within the legal framework,[1] led by the Superintendency of Corporations (Superintendencia de Sociadades, SOC) in coordination with other institutions such as the Ministry of Finance and Public Credit (Ministerio de Hacienda y Crédito Público, MFPC) of the central government. In contrast, the courts take the center seat in local government insolvency proceedings in Hungary and the Unites States.[2] The unique role of the SOC in Colombia arose in an historical context where the court system was weak, and thus an alternate arrangement was created, in which the SOC administers bankruptcy procedures for both corporations and most government entities.[3]

Increasingly, SNGs in Colombia used the Law 550 process not because they borrowed too much from lenders, but because other claimants (wage earners, suppliers, and so forth) have gotten court judges, outside the SOC, to recognize their claims to the unpaid SNG bills. The embargos by courts—using intercepts of fiscal transfers and bank accounts—force subnationals to pay these bills, with added penalties and interest payments. By initiating a bankruptcy process under Law 550, SNGs can obtain a halt to the embargoes, past and prospective, and go through orderly restructuring of their debts. The essence of the 550 proceeding is to evaluate and reconcile competing claims against the subnational debtor, according to a defined priority structure.

There has been little divergence between the law and actual practice for dealing with subnational insolvency, in the sense that essentially all the debt restructuring and adjustment operations have been done according to procedures prescribed in the laws. Nonetheless, for any one subnational situation, each of the laws, and (even more), the group of laws, provides a variety of options for how to address the problems. Thus, understanding the actual practice requires seeing which options are usually chosen and why.

To understand Law 550—its origins and its practice—we review the evolution of the intergovernmental fiscal policy and context of the other laws that regulate it. The remainder of the chapter is structured as follows. Section two presents the structure of the Colombian decentralization framework and its development since decentralization started. Section three shows how the borrowing framework developed in order to provide both ex-ante fiscal rules and debt limitations and ex-post-bankruptcy proceedings, as well as to enhance transparency in the context of SNGs' medium-term fiscal frameworks. Section four describes the Law 550 framework for insolvency proceedings. Section five reviews the law's implementation and evaluates its effects. Section six summarizes and concludes.

Structure and History of Subnational Governments[4]

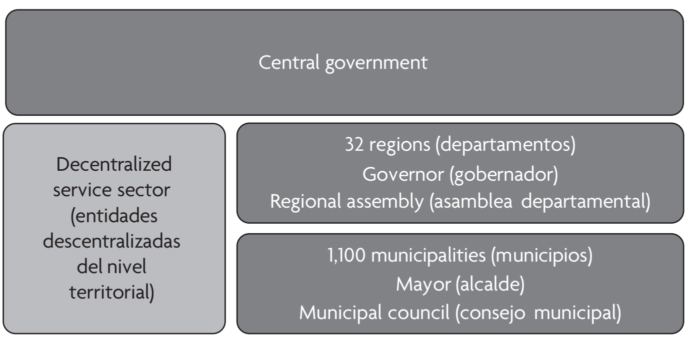
Colombia is a unitary republic composed of 32 regions (departamentos) and around 1,100 municipalities (municipios). Ten of these municipalities have the status of districts, which also manage the expenditures of the department in which they are located. Each department has a governor (gobernador) and a department assembly (asamblea departamental), both of which are elected by popular vote for a four-year term. The municipal governments are headed by a mayor (alcalde) and administered by a municipal council (consejo municipal), which are also elected for four-year terms (see figure 5.1).

Decentralization History and Challenges in the 1990s

Until the early 1970s, Colombia was a strongly centralist country. National agencies controlled most of the subnational spending programs. This situation started to change with the constitutional reforms adopted in 1968 that obliged the central government to share its current revenues with SNGs through the so-called *situado fiscal*.[5] In addition, the reforms allowed SNGs to provide local services through public companies and decentralized service entities that are independent from the central government, and municipalities were granted autonomy to plan and coordinate local development and to provide services under the supervision of the departments (Bird 1984).

Political considerations led to important extensions of decentralization in the 1980s. The Constitutional Reform of 1986 (Acto Legislativo 01) introduced popular elections for mayors starting in 1988, and Decrees 77 to 80 of 1987 transferred to municipalities the responsibilities for spending on basic infrastructure and social services.[6] Law 14/1983 widened the tax base for municipal and departmental taxes and also prescribed the ranges within which the SNGs could set their taxes, in order to avoid destructive tax competition or a negative

Figure 5.1 Government Structure in Colombia



Source: Authors, based on the Colombian constitution.

impact on Colombia's international competitiveness. Revenue sharing also increased substantially with Law 12/1986, which intended for the national government to increase the transferred share of the value-added tax up to 50 percent by 1992. Until the 1991 Constitution, the president appointed the governors of departments, making them more like deconcentrated branches of the national government than autonomous subnational entities. Thus, the decentralization of the 1980s was largely to the municipal level. This experiment was deemed a failure, however, because too many municipalities lacked the administrative capacity to deliver services, and some were being overrun by guerilla insurgencies (Dillinger and Webb 1999; Sánchez and Gutiérrez 1995; Rojas 2003).

Decentralization accelerated substantially with the 1991 Constitution, which made the office of governor an elected post and (together with Law 60/1993) committed the national government to increase the amount of transfers assigned to subnational entities each year until it reached 46.5 percent of the central government's current revenues by 2002. These transfers were complemented by a system of natural resource royalties (*regalías*) that would remain mostly in the producing and transit localities, and a system of cofinancing in which the central government would transfer funds conditional on the participation of local governments for projects in the areas of urban and road infrastructure (Ahmad and Baer 1997; Dillinger and Webb 1999). The government plans to revise the rules for the royalties in 2012.

The transfer system that resulted from the 1991 constitutional changes focused on the financing of education, health, and water and sanitation in order to equalize the provision of these services across regions. In addition, municipalities with a population of less than 30,000 could use up to 28 percent of these transfers to pay for working expenditures. However, the rapid increase of transfers, which could serve as collateral, also stimulated the growth of expenditures and debt in territorial governments[7] and diminished the incentives for SNGs to raise their own revenue. On top of the growing transfers, SNGs ran current fiscal deficits and new municipalities were created to gain access to transfers. The number of municipalities increased from 745 to 998 between 1994 and 1999. At the same time, the transfer system constrained the possibility of balancing central government finances, because 46 percent of any increase in current revenues went out to subnationals as additional transfers. Similarly, countercyclical fiscal policy by the central government became less effective, because subnational expenditures were cyclical with current revenues (Dillinger and Webb 1999).

Together with enhanced political autonomy and the responsibility for local public service delivery, the transfer of current revenues to SNGs increased from 13 percent of national government revenue in 1973 to 49 percent in 1999. Since then, transfers as a share of total SNG revenues have declined, to less than 40 percent by 2010, partly because SNGs were increasing their own revenues (see figure 5.2).

The increasing expenditure responsibilities of SNGs were not matched by adequate own-resource instruments, and transfers were excessively earmarked. Smaller SNGs struggled to cover the share of operating expenses that were not funded by transfers but had little incentive to manage other expenditures effectively. Besides the absence of fiscal responsibility institutions in these years, intergovernmental fiscal relations also suffered from the lack of institutions to ensure

Figure 5.2 Regional Transfers to Subnational Governments as a Share of Current Central Government Revenues, 1994–2010

Source: Balance Fiscal Gobierno Nacional Central 1994–2010, MFPC, http://www.minhacienda.gov.co.
Note: Colombia fiscal year = calendar year.

adequate allocation and use of transfers and to incentivize SNGs to generate own revenues and provide required matching funds (Rojas 2003).

The above situation blunted the SNGs' incentives for fiscal discipline. Various factors had contributed to the fiscal and debt crisis at the subnational level in the 1990s, compounded by the economic recession in the late 1990s to early 2000s, which added to the fiscal problems at the national level.

Starting in the late 1990s, the national government introduced a series of measures to bring subnational finances under control: increasing their own revenue collection, making fiscal transfers to SNGs more predictable in real terms, and introducing a legal and regulatory framework for fiscal responsibility in SNGs. The framework includes procedures to deal with insolvency of subnational entities; stronger limits on current expenditures, especially the wage bill; and procedures to implement adjustment plans and overcome insolvencies for SNGs. These measures, along with, among other things, the economic growth since the mid-2000s, helped Colombia constrain unsustainable subnational debt accumulation and contributed to the relatively healthy fiscal situation today in most of Colombia's subnationals.

Subnational Responsibilities and Resources

Expenditures by SNGs averaged about one-third of total government expenditures from 2005 to 2010,[8] with the combined spending accounting for about 27.5 percent of gross domestic product (GDP) during the same period. The share of SNGs in public spending overstates the fiscal autonomy of SNGs, however, because nearly half of subnational spending consists of earmarked transfers in the education and health sectors. This leaves the SNGs only limited control over resource allocation.[9]

SNGs depend heavily on transfers from the center, which represent around 58 percent of their total revenues. Currently, there are three main transfers: the General Transfer System (Sistema General de Participaciones, GTS), direct royalties, and *rentas cedidas* (central government taxes earmarked for certain local administrative activities). The share of these transfers account for 47, 9, and 2 percent of total SNG revenues, respectively, and much of the GTS is earmarked for education and health services (table 5.1). The share of transfers varies widely, with

Table 5.1 Total Revenues of Subnational Governments, Percentage of Total, 2006–10

	2006	2007	2008	2009	2010
Total revenue	100	100	100	100	100
Tax revenue	29	30	28	29	29
Nontax revenue	8	7	5	6	6
Transfers (funcionamiento)	2	2	2	3	2
Royalties	7	8	10	8	9
CGT	45	47	46	46	47
Cofinancing	2	3	1	2	2
Others	7	4	7	7	5

Source: NPD, Desempeño Fiscal de los departamentos y municipios, 2010.
Note: CGT = Central Government Transfers; data may not tally due to rounding of decimals.

large municipalities being mostly self-financed and small municipalities and poor departments depending almost entirely on transfers. Some SNGs with hydrocarbon and other mineral exports are well financed with royalties.

Before 2001, transfers made subnational revenues and expenditures strongly procyclical, because the transfer formula was directly linked to current central government revenues. The constitutional reforms in 2001 and 2007 and Laws 715/2001 and 1176/2007 delinked transfers from central government current revenues and clarified the distribution of competences among different layers of government. The 2001 reforms aggregated most of the previous transfers[10] into the GTS and set it to grow on a real basis unrelated to central government revenues. As a result of the reforms, transfers to SNGs have followed a predictable path without the volatility of the late 1990s.[11] Today, the GTS is the largest transfer, amounting to 4.2 percent of GDP or 34 percent of central government current revenues and accounting for 47 percent of subnational revenues.[12]

Under the 1991 Constitution, SNGs of regions producing minerals (mainly oil and coal) and serving as ports for exports keep the main share of natural resource royalties. Law 756/2002 specifies the royalty rate, which depends on the type of natural resource and the value of production in the entity. Up to 32 percent of the value of production is reserved for the National Royalty Fund (*Fondo Nacional de Regalías*), which was established to finance mining development, environmental protection, and regional development projects nationwide. The remainder is distributed among producing departments, producing municipalities, and port municipalities, and these funds may be used only for investment in the National Pension Fund (Fondo Nacional de Pensiones en las Entidades Territoriales, FONPET), education, health (infant mortality, and health-for-the poor projects), or water supply and sewerage.[13] The oil price boom since the mid-2000s—even since 2008, prices have remained high by historic standards—has kept revenues in these subnationals above trend, and for those that have borrowed on that basis, a sustained fall of oil prices would bring a debt problem.

Besides transfers and royalties, departments and municipalities also levy taxes. Tables 5.2 and 5.3 disaggregate them by departments and municipalities. On average, own revenue as a share of total revenue is 26 and 31 percent for departments and municipalities, respectively. While these values are relatively low compared with the expenditures responsibilities,

Table 5.2 Department Revenues
thousands of millions of Colombian pesos

Revenue	2010	Percent
Departmental taxes		% of tax revenue
Car	374	7
Registry	392	8
Liquor	936	19
Beer	1,435	28
Cigarettes and tobacco	565	11
Fuel sobre tasa	280	6
Others	1,054	21
		% of total
Tax revenue	5,036	26
Transfers	9,749	50
Royalties	2,845	14
Nontax revenue	1,108	6
Cofinancing	339	2
Others	616	3
Total revenue	19,693	

Source: NPD, Desempeño Fiscal de los departamentos y municipios, 2010.
Note: Data may not tally due to rounding of decimals.

Table 5.3 Municipal Revenues
thousands of millions of Colombian pesos

Revenue	2010	Percent
Municipal taxes		% of tax revenue
Unified property tax	3,339	31
Tax on gross business receipts	4,522	42
Fuel sobre tasa	1,100	10
Others	1,930	18
		% of total
Tax revenue	10,891	31
Transfers	17,682	50
Royalties	1,850	5
Nontax revenue	1,945	5
Cofinancing	622	2
Others	2,418	7
Total revenue	35,408	

Source: NPD, Desempeño Fiscal de los departamentos y municipios, 2010.
Note: Data may not tally due to rounding of decimals.

the own-revenue base of SNGs is much higher than in other unitary Latin American countries (World Bank 2009).

Departmental tax bases are narrow, with the bulk of resources being raised by taxes on alcohol, liquor, and tobacco, although in some wealthier departments the tax on vehicle ownership is important. Compared to departments, municipalities have a greater tax base, with the property tax and the tax on gross business receipts (impuesto de industria y comercio), which each contribute 30 and 40 percent, respectively, to the total municipal tax revenues, on average. The remainder comes from a host of other, minor taxes. Large municipalities raise more own revenue than the average, and small municipalities raise much less, often almost nothing in poor and remote places. Thus, own-revenue capacity of SNGs varies widely, and with it their capacity to service debt. As shown below, the fiscally stronger SNGs borrowed heavily in the 1990s and got into debt trouble, but in the 2000s, most of the entities with debt problems were smaller and poorer. Their debt problems arose less from formal borrowing than from arrears and other manifestations of general problems with governance and financial management.

Subnational Debt

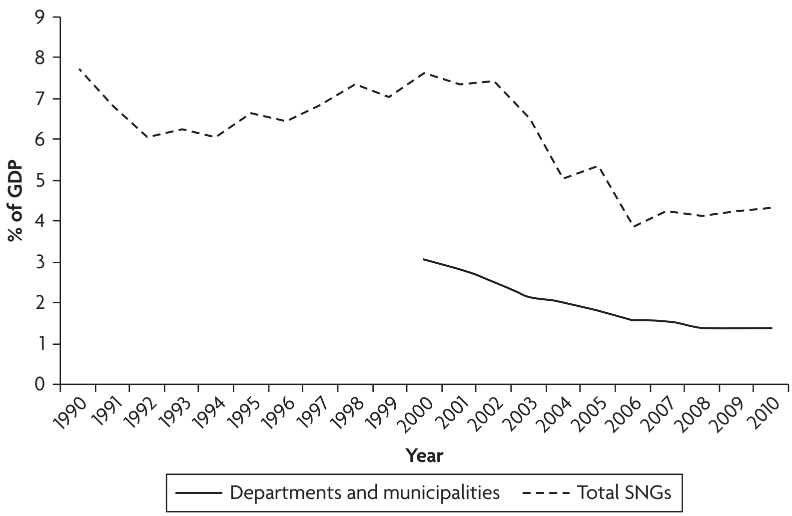
Subnational Borrowing Trends

The 1991 Constitution gave territorial governments substantial autonomy over borrowing and bond issuance (Art. 287 of Carta Constitutional). The 1986 administrative regulation on debt limits still governed subnational borrowing. SNGs could borrow, including for current expenditures, as long as the ratio of debt service to current income was below 30 percent, and municipalities could incur higher debt levels if they were approved by the MFPC. Borrowing had to be approved by the departmental assembly or the municipal council. Art. 364 of the Constitution also stated that the debt of an SNG should not exceed its payment capacity, but the implementing law was only adopted in 1997 and applied in 1999, when the country was already in financial and fiscal crisis.

Subnational borrowing increased in the 1990s. The increase in central fiscal transfers through Law 60/1993 stimulated borrowing from banks, which treated territorial entities as preferred debtors based on the formula-based transfers from the center. Banks were not sufficiently aware of the norms for subnational budgetary rules, and their risk management did not assess the real capacity to pay. Instead, they focused on the availability of collateral in the form of royalties and transfers, ignoring what claims other parties might already have on the same collateral. Also, many of the credits were used to finance current expenditures or investment projects with delayed payment streams. A central problem was that the transfers and the competences of the SNGs were not always aligned. Operational expenditures were growing at a higher rate than own revenues, which led to a build-up of current deficits. Current local expenditures as a share of local tax revenues increased between 1990 and 1999 from an average of 140–170 percent in municipalities and from 169 to 314 percent in departments, with the gaps covered by transfers and credit.

The combination of political autonomy, weak bank lending supervision, excessive reliance on transfers, and permission to borrow for current expenditure blunted SNGs' incentives for fiscal discipline. The economic slowdown in the late 1990s to early 2000s also weakened the subnational fiscal accounts. Subnational debt increased from about 6 percent of GDP in the mid-1990s to 7.6 percent in 2000 (figure 5.3). The decentralized service entities—utility companies owned by SNGs—account for a significant share of subnational debt.

Figure 5.3 Subnational Government Direct Debt as Percentage of GDP, 1990–2010



Source: Fiscal Affairs Department (Departamento de Asuntos Fiscales, DAF).
Note: The solid line reflects SNGs' total debt, including decentralized service entities; the dotted line sums only department and municipality debt. GDP = gross domestic product, SNG = subnational government.

Although the debt level was not high by international comparison, there were two problems. First, the arrears (which are not included in figure 5.3), had been increasing. Second, the capacity of SNGs to service the direct debt had weakened, due primarily to the decline in own revenues and fiscal transfers. The National Planning Department (Departmento Nacional de Planeación, NPD) calculated fiscal performance indicators for all municipalities under Law 550. Table 5.4 compares the indicators for the municipalities under Law 550 debt restructuring with the national average, and it distinguishes municipalities according to the status of their debt restructuring agreement as of the end of 2011. Nineteen municipalities out of the 26 that had successfully completed the agreement (73 percent) were above the national average in this indicator. For the municipalities that were still carrying out the agreement, only a slight majority (41 percent) had indicators above the national average. Most of the municipalities with failed agreements had indicators below the national average, as one would expect.

At the height of the problem in 2000, external creditors accounted for 38 percent of total SNG debt, and this declined to 30 percent as of

Table 5.4 Fiscal Performance of Municipalities under 550 Debt Restructuring Agreements Compared to the National Average for All Municipalities

Municipalities	Fiscal performance above national average	Fiscal performance at or below national average
Restructured debt fully paid off, as per 550 Agreement	19	7
550 Agreement still being carried out as of 2011	19	27
550 Agreement still being negotiated	2	4
550 Agreement failed	2	7

Source: NPD calculations, as of 2011.

end-2010—falling from 3.5 percent to 1.3 percent of GDP, as shown in table 5.5. Subnational debt is highly concentrated in terms of the number of borrowers. The decentralized service entities—utility companies owned by SNGs—account for about two-thirds of SNG borrowing, both domestically and overseas. Twenty entities, including the capital city Bogotá and 10 decentralized service entities, account for 88 percent of subnational debt.

At the department level, for its domestic debt composition, the largest source of subnational credit has been commercial banks—74 percent of the total. The rest consisted of central government on-lending (8 percent), bonds (5.6 percent), and the government-owned FINDETER INFIS[14] (2 percent), as of end-2010.

Capital markets remain small in Colombia. As of June 2010, only six subnational entities have issued bonds, of which three are SNGs, and three are decentralized service entities (that is, utility companies).[15] Most of the SNG bonds have been paid off; only Bogotá still had outstanding bonds as of June 2010.

Overborrowing from banks in the late 1990s was concentrated in departments and bigger municipalities. Smaller municipalities more typically did not have a lot of bank debt, but rather accumulated arrears on salaries, contributions to pension funds, social security contributions, and payments to providers. The combination of increasing interest rates and slower growth in the late 1990s led to an unsustainable fiscal situation for SNGs (Dillinger and Webb 1999; Rojas 2003).

Since the early 2000s, the SNGs overall have improved fiscal balances, going from an aggregate deficit of 1 percent of GDP in 1999 to a surplus

Table 5.5 Composition of Subnational Debt as Percentage of GDP, 2000–10

	2000	2003	2007	2008	2009	2010
Domestic	5.6	4.9	3.5	2.9	2.8	3.2
Departments	1.28	0.95	0.51	0.40	0.40	0.40
Capital municipalities	1.13	1.01	0.71	0.50	0.40	0.40
Municipalities	0.41	0.27	0.22	0.20	0.20	0.30
Decentralized entities	2.76	2.68	2.09	1.80	1.80	2.10
External	3.5	2.8	1.80	1.5	1.6	1.3
Departments	0.01	0.05	0.03	0.03	0.03	0.03
Capital municipalities	0.42	0.47	0.37	0.30	0.30	0.30
Municipalities	0	0	0	0	0	0
Decentralized entities	3.1	2.3	1.4	1.2	1.3	1.1
Total	9.1	7.7	5.3	4.4	4.4	4.5

Source: DAF, MFPC: Informe sobre la Viabilidad Fiscal de los Departamentos, Vigencia 2010.
Note: GDP = gross domestic product.

of 1 percent in 2008.[16] Thus, the problem of SNG debt since the early 2000s was not large in the aggregate size of the debt, but rather that the debt was concentrated in a small number of places, often those with guerrilla and drug problems. Thus, having instruments to deal with these places—failed SNGs—was important more for political and social reasons than for dealing with a macroeconomic problem. Both the number of places and the size of the drug problem have declined since the early 2000s. The strengthened regulatory framework, as explained in the next section, together with the turnaround in the economy and the broader reform in the intergovernmental fiscal system, have contributed to the improved subnational fiscal and debt position.

When SNGs have gotten into fiscal distress and excess indebtedness since the early 2000s, it has usually not resulted primarily from formal spending and borrowing from banks and capital markets, given the new fiscal rules on direct borrowing. Rather, much of the excess debt has arisen from arrears in payments to employees, national tax authorities, and suppliers, and from contributions to pension funds, from court judgments against the SNGs, and from penalties and interest accrued on these. Sometimes these arrears occurred when the subnational treasury was unable or unwilling to pay. In other cases, there was collusion between the claimant and a local official—and perhaps also with participation of a lawyer and a judge—who agreed to a delay of payment in order to be able to sue later for a much larger amount including penalties and interest for the late payment. A judge could then embargo (sequester) the bank accounts of the local government in order to seize central government transfers for payment of these judgments. Such conjunctions of legalism and collusions have negatively impacted the finances in a few localities, and the central government has adopted various legal and administrative measures to try to protect legitimate public finances. Such occurrences are more frequent in places with a high incidence of poverty and violence—and with influence by narcotraffickers, guerillas, or the paramilitary.

Legal Framework for Subnational Borrowing

The subnational borrowing framework in Colombia developed in parallel with the political and fiscal decentralization and the fiscal crisis discussed above. The goal of the borrowing framework, developed mostly during 1997–2003, was to avoid situations of fiscal and debt distress in SNGs. However, if the ex-ante constraints on borrowing were insufficient, then the ex-post insolvency procedures discussed in the next section could be applied.

Cross-country experience shows that deficits and debt arise from the joint decision of governments and their creditors (including suppliers allowing extended payments). These decisions are made in light not only of the rules governing issuance of the debt, but also the ex-ante expectations about what will happen to the debtor and the creditors if payment difficulties arise—who will lose money or who will be forced into painful adjustment. The decisions of that lending moment become a fait accompli conditioning the subsequent decisions. This points to two important dimensions of control of government borrowing: (a) their type and timing relative to the initial lending decision, that is, ex-ante controls or ex-post consequences; and (b) whether the ex-ante controls and ex-post consequences act on borrowers or on lenders, as displayed in table 5.6 (Liu and Webb 2011).

The legal framework currently governing Colombia's subnational borrowing and insolvency is summarized in table 5.7, which corresponds to the four quadrants shown in table 5.6.

The first major step to increase the ex-ante control of subnational debt was Law 358/1997, which forbade borrowing to finance current

Table 5.6 Channels for Control of Deficits and Debt: Lender-Borrower Nexus and Timing of Controls and Sanctions

Timing relative to lending decision	For borrowers	For lenders
Ex-ante controls	*All governments* • Debt and deficit ceilings • Restrictions on international borrowing • Publication of detailed fiscal results *SNGs only* • Regulation of SNG borrowing, based on fiscal-capacity criteria (regulations by central government or SNG itself, central bank, or other institution)	*All governments* • No direct central bank financing • Regulations by central bank or other financial supervision agency *SNGs only* • Cap on total borrowing by SNGs • Increased capital requirements for lending to risky SNGs
Ex-post consequences	*All governments* • Limits on central bank financing • No bailouts (from central government or from international community) and no debt workout without adequate conditionality • Publication of detailed fiscal results *SNGs only* • Central government does not accept SNG debt • Debt service withheld from transfers to SNGs • Insolvency system	*All governments* • Strong supervision of banks *SNGs only* • Regulations require capital write-offs for losses from SNG debt • No central bank bailouts • Well-functioning financial market can increase risk premium for lending

Source: Adapted from Liu and Webb 2011.
Note: SNG = subnational government.

expenditures and linked subnationals' issuance of new debt to their overall payment capacity. This so-called Traffic Light Law (Ley de Semáforo) introduced a rating system for territorial governments based on a liquidity indicator (interest payment/operational savings[17]) and a solvency indicator (debt/current revenue). Both indicators had to be calculated for each new loan, determining whether the entity had the capacity to incur further borrowing. Any SNG in the red light category was prohibited from borrowing without case-by-case permission from the MFPC.[18] Entities in the yellow light category could contract new debt if the percent increase in debt outstanding was lower than the Consumer Price Index inflation for that year. Otherwise, municipalities and departments had to obtain permission for new credit from the departmental governor or the MFPC (see table 5.8).[19]

The MFPC could make the permission conditional on the adoption by the SNG of an adjustment program that included measures to

Table 5.7 Ex-Ante and Ex-Post Fiscal Legislation

	Borrowers	Lenders
Ex-ante controls	*Regulation of borrowing based on fiscal capacity* • Law 358/1997 and Law 795/2003: Traffic light system links borrowing to ability to pay • Law 617/2000: Limits on current spending and new classification of capacity to pay • Law 819/2003: Budget management and transparency rules	*Ban on credits to SNGs in violation of limits of Laws* 358/1997, 617/2000, 795/2003, and 819/2003
Ex-post consequences (incentives for ex-ante caution)	*Central government does not bail out SNGs* • Law 549/1999: Creation of the Pension Fund for Subnational Governments • Ban on financial support of SNGs that are not in line with Laws 358 and 795 • Debt service withheld from transfers in restructuring agreements • Law 550/1999: Restructuring of insolvent subnational entities • Decree 28/2007	*Write-offs required for losses from SNG debt* Law 550/1999 Law 617/2000

Source: Adapted from Liu and Webb 2011.
Note: SNG = subnational government.

cut costs and improve own-revenue collection in order to reestablish economic and financial stability and guarantee the repayment capacity (Art. 9). The adjustment program would be active until the ratio of interest payments/operational savings declined below 40 percent. The SNGs undergoing such a program had to report on a quarterly basis to the Fiscal Affairs Department (Departamento de Asuntos Fiscales, DAF), which evaluated the implementation of the program, in coordination with the comptroller general of the republic. Not implementing the adjustment programs and obtaining new borrowing in violation of the limits established by the law could lead to sanctions. Also, the Superintendency of Banks could penalize financial institutions that gave credits to subnational entities in violation of Law 358/1997 (Art. 10).

Despite Law 358/1997, some governments with a red-light rating obtained new financing without MFPC permission by presenting defective financial information, which was only superficially analyzed by the creditors. In addition, the MFPC gave its authorization in cases where it should have denied it. As a result, department debt indictors deteriorated from yellow to red instead of improving from yellow to green, and subnational debt still grew by 15 percent a year, on average, during

Table 5.8 Indebtedness Alert Signals

Indicator	Autonomous indebtedness green light	Intermediate indebtedness yellow light	Critical indebtedness red light
Debt interests/ operational savings[a] (liquidity indicator)	< 40%	40% < 60%	> 60%
Debt balance/current revenue (solvency indicator)	< 80%	< 80%	> 80%
Effect	Territorial Entity (Entidad Territorial, ET) is allowed to contract new credit autonomously.	(a) ET can contact autonomously. (b) Requires indebtedness authorization of the Ministry of Finance or the department, which will be conditioned to the signing of a Performance Plan with the financial institutions.	Authorization is required to contract credit operations, thus a Performance Agreement with the financial entities should be signed.

Source: MFPC.
a. Operational savings is defined as current revenue – current expenditure (excluding interest payments).

1998–2000. Similarly, in the absence of a fixed ceiling on current expenditures of the core administration, adjustment programs did not always bring about stronger fiscal discipline at the local level. As a result, the current expenditures of the core administration continued to rise fast, and subnational entities remained dependent on transfers (Echavarria, Renteria, and Steiner 2002).

Law 617/2000 introduced a more systematic framework for ex-ante measures to avert fiscal crisis, by controlling the growth of operational expenditures. For this purpose, Law 617 classified departments and municipalities according to population size and the amount of freely disposable (nonearmarked) revenues, and set limits on the ratio of discretionary current expenditure to nonearmarked current revenues. These limits were established in the law and depend on the size of the SNG. At the same time, the central administration (including the central bank) was not allowed to make transfers to SNGs that did not meet the requirements, and an extensive list of requirements for the election of governors, mayors, legislators, and their relatives aimed to increase transparency.

SNGs that exceeded the limits set forth in this law had to execute a fiscal adjustment program with precise performance targets in order to regain fiscal viability. The NPD and the MFPC supervised the execution of the adjustment plan for municipalities and departments, respectively. The NPD could order a new adjustment program should a municipality fail to meet the targets in its original program. Should a municipality again fail to establish viability within two years, it might be required to merge with another municipality, although this never actually happened.

In addition, Law 617 allowed SNGs under specific conditions to request a central government guarantee for up to 100 percent of new credits that were contracted to finance fiscal adjustment plans (for example, the costs of personnel retrenchment) that were endorsed before June 30, 2001. To benefit from a guarantee, the territorial entities (a) had to be in need of a fiscal adjustment program but without own resources to implement it, (b) had to commit to implement it in line with the modalities established by the law, and (c) needed to have debt that had to be restructured to reestablish payment capacity. At the same time, SNGs' creditors had to commit to give new credits to finance the fiscal adjustment program, and the liabilities had to be restructured in a way that assured payment capacity.

In 2003, Law 795 and Law 819 further strengthened the borrowing framework for subnational entities. Art. 120 of Law 795 eliminated the yellow category of the traffic light system. Entities previously categorized as yellow then fell under the red rating, tightening the borrowing restraints on SNGs. The 2003 Fiscal Transparency and Responsibility Law, Law 819/2003, strengthened the traffic light system, adding to the indicators from Law 358/1997 the requirement that the budget has to be balanced over a 10-year period. The law also increased transparency and improved fiscal coordination among different levels of government, since it required both the central administration and local governments to present each year a consistent 10-year macroeconomic framework. Expenditure authorizations and revenue collection at all levels of government had to be consistent with this framework, and any deviations from the framework had to be authorized by the MFPC. Both the central and subnational budgets had to fully comply with the medium-term frameworks. Law 819 also introduced market-based incentives, since it required all subnationals with populations over 100,000 to get a credit-risk rating by a rating agency.

The laws also tightened the regulations on the credit supply side, prohibiting central government financial support to subnational entities that were not adhering to the fiscal responsibility norms contained in Laws 617 and 358, or that had debt service arrears for credits to the national government or for credits that were guaranteed by the nation. Furthermore, credits from financial and territorial development institutions that did not meet the conditions and limits of Laws 358, 617, 819, and 795 were invalid, and borrowed funds had be restituted promptly without interest or any other charges. This would be punishment for both creditors and borrowers. The MFPC through the DAF monitors the adherence of the decentralized entities to the different borrowing and fiscal limits mentioned above.

While the above laws strengthened ex-ante regulations of subnational debt limitations and fiscal management for both borrowing governments and lenders, Law 550/1999 addressed the bankruptcy proceedings for SNGs. The details of the content and implementation of Law 550 and its relationship to Law 617 as part of debt restructuring are discussed in the next section, "Insolvency Procedures: Implementation and Effects."

The national government was concerned not only about imprudent and unsustainable fiscal behavior by SNGs, but also about failures to deliver essential services, especially those financed by earmarked transfers. To address the poor service delivery by a few SNGs in sectors financed with transfers, the Colombian Congress approved in 2007 the Acto Legislativo No. 04, which the executive branch regulated through Decree 28 in January 2008. Both rules authorized the executive branch to monitor and control subnationals in the use of earmarked resources financed by the transfer system. Since entities that get into debt difficulties often, although not always, have similar problems in service delivery, Decree 28 provides for an extreme penalty and loss of local control for subnationals that do not cooperate in a fiscal reform agenda, including insolvency proceedings.

Decree 28 thus added a new element and incentives in the institutional framework that impact the fiscal management of SNGs. The power of the central government to intervene, when the use of transfers does not fulfill the expected legal requirements, strengthens the power of the central government for fiscal oversight and for avoiding situations where the judicial process impounds their transfers. SNGs with poor fiscal management face not only the risk of being subject to adjustment plans defined on the basis of the fiscal insolvency framework; the central government might also directly take over their financial management.

Insolvency Legal Framework

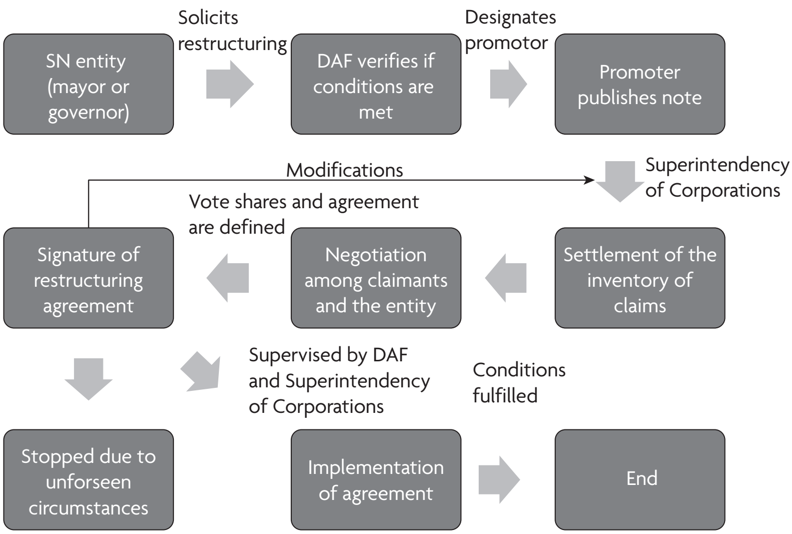
Subnational entities that surpass the spending and debt limits established in Laws 358/1997, 617/2000, and 819/2003 must undergo fiscal adjustment plans as described above. In addition, Law 617/2000 also includes the possibility of restructuring debt and obtaining guarantees and cofinancing to help subnational entities implement the measures as outlined in the adjustment plans. A subnational entity that becomes insolvent, defined as being overdue on payments for at least 90 days, including court-ordered payments, can also request protection under Law 550/1999—Colombia's subnational insolvency or bankruptcy law—in exchange for a commitment to reduce expenditures and redirect revenues to pay creditors through a restructuring agreement.

Law 550/1999 was introduced as a financial restructuring law for both private sector companies and subnational entities. The subnational entities covered are departments, municipalities, and districts, as well as the parts of the decentralized service delivery sector (entidades decentralizadas del nivel territorial) that are not overseen by any sectoral superintendency.[20] Law 550/1999 was supposed to remain in place for five years but was subsequently extended and finally made permanent for subnational entities by Law 1116 (Art. 125 and Art. 126) of 2006.[21]

Under the jurisdiction of Law 550, subnational entities are protected from any outstanding or new payment obligations and any court orders to pay once the insolvency proceedings under Law 550/1999 begin. The restructuring agreements seek to evaluate, reconcile, and restructure competing claims on subnational debtors. The insolvency proceeding is designed to be transparent, with public notices at all stages of the process, including disclosing the restructuring agreement.

Institutional arrangement, process, and triggers. The intervention under Law 550/1999 is an administrative process, with the SOC acting as judge. The SOC, a unique institutional arrangement in Colombia,

Figure 5.4 Restructuring Process under Law 550/1999



Source: Summary by authors based on consultation with DAF.
Note: SN = Subnational, DAF = Fiscal Affairs Department (Departaments de Asuntos Fiscales).

handles all insolvency cases, due to the recognized weakness of the court system in the country. The parties involved in the subnational process are the concerned debtor, the creditors and other claimants, the promoter (to supervise and facilitate the restructuring proceedings), and the MFPC. Four types of creditors are distinguished: (a) workers and pensioners, (b) public entities and social security institutions, (c) financial institutions and other entities that are under the supervision of the Superintendency for Banks, and (d) other claimants (suppliers, contractors, and so forth). In the case of decentralized service providers, creditors can also be internal to the entity, such as shareholders or members of the service providers. Law 550/1999 outlines in detail the process for restructuring agreements, as summarized in figure 5.4.

A subnational entity can request debt restructuring under Law 550 if two or more payment obligations are overdue for at least 90 days or at least two court payment orders have been issued. The accumulated value of the obligations in arrears must represent at least 5 percent of the total of obligations that fall due in less than a year. The process is initiated by a request sent to the DAF by the legal representative of the concerned subnational entity with the local congress's authorization.

Next, the DAF verifies that the above-mentioned conditions are fulfilled and, if they are, accepts the request to start the restructuring agreement negotiations. The DAF designates a civil servant or contractor to act as a promoter to supervise and facilitate the debt restructuring negotiations. The promoter checks the accuracy of the financial statements and projections, keeps all involved parties informed, and coordinates the negotiations. The promoter also calculates the voting rights of the creditors and is part of the committee that supervises the execution of the agreement (Art. 8, 550). Although the promoter does not vote on the agreement or any modifications thereafter, she or he plays a pivotal role in informally advising the subnational debtor and representing the views of the DAF, whose support is usually needed for the restructuring to succeed.

Once the negotiations start, public services that were suspended must be resumed, and all existing or new payment orders, legal claims (procesos de ejecución), and seizures of assets are suspended and no new ones can be initiated. The entity is not allowed to make any payments or contract any new obligations that are not strictly necessary to sustain service provision, except with written previous authorization of the DAF.[22] Administrative costs (mainly wages and utility bills) must be paid during the negotiations and the life of the restructuring agreement and have priority over other claims. Creditors whose claims are guaranteed by specific collateral with the entity must decide whether to call the guarantee (take the collateral) or to include the claim in the restructuring agreement. Other creditors' claims (including those who got judicial embargoes) are put on hold until the agreement is signed.

An important responsibility of the promoter is to determine the voting rights of the individual creditors. The elements included in the calculation vary among creditors. For instance, the voting-share value of claims from labor, pension funds, and tax authorities include interest and penalties. Pension fund claimants get an extra 25 percent voting weight added to the principal of their recognized claim. Voting rights for financial sector and other claimants, in contrast, are based on only the principal overdue, excluding interest or penalties that have not been legally capitalized.

The law provides four months for the promoter to create the inventory of claims and thus set the voting shares of the claimants and then, if the claimants accept the inventory, the claimants and the entity have four additional months to reach and sign an agreement. The process usually meets these two deadlines. Delays often come in the middle, when claimants protest because they are not satisfied with the size of liabilities they are assigned in the inventory. The SOC then resolves the disputes, which usually takes 6–12 months. The negotiations conclude with the voting on the agreement, which becomes binding if it is accepted by at least 51 percent of the votes.[23] The voting weight of each claimant in negotiating and settling on the restructuring agreement depends on the amount owed to the claimant (Art. 22); those with the largest claim (as settled in the middle part of the 550 process, with the SOC as referee) get the largest weight in determining the terms of the agreement, although the majority of claimants voting in favor must include at least one claimant from at least three categories. The agreements establish an 18-month period, starting when the agreement is signed, to go through the contingent liabilities, except those that require a judicial pronouncement to be recognized.

The format and content of the restructuring agreement are also regulated in detail: It must be in written form, signed by all creditors who have voted in its favor, and deposited with the DAF (Art. 31). The agreement must outline detailed rules for the financial and administrative planning and execution of the entity, and the modalities and conditions for the payment of pension, labor, social security, and fiscal liabilities during the restructuring period. The agreement must also outline the contribution to the pension fund, FONPET, and the conditions and modalities to repay its creditors. In addition, the agreement must establish and outline the rules of an Agreement Supervisory Committee, which consists of all the creditors and the promoter, who has a voice but no voting rights. Other issues addressed in the agreement include the procedures in case of failure to fulfill the obligations in the agreement and, if necessary, any special labor agreements during the life of the agreement.

The Superintendent of Banks does not seem to be an important player in the negotiations, although it plays a background role by enforcing the regulations for classifying the riskiness of loans and the corresponding capital risk weighing and provisioning, which helps shape the incentives of the financial institutions as they participate in negotiating the restructuring agreements. More important is the sister agency, the SOC. As the insolvency authority, the SOC plays a key role in settling disputes over the amounts of claims from various claimants and in helping to supervise implementation of the agreements.

Priority structure. The agreement also establishes the priority of payments, which must be in accordance with Art. 58, which establishes the following order:

1. Pension contributions to individual accounts by subnational entity
2. Salaries (servicios personales)
3. Payroll transfers (transferencias de nómina)
4. General expenditures (gastos generales)
5. Other transfers
6. Interest payments
7. Amortization of debt
8. Financing of the deficit of previous years
9. Investment expenditure contracts.

The labor claimants and fiscal (tax) claimants (including the pension funds) must be paid in full for the claims that are recognized, but the timing of these payments is negotiated and set in the restructuring agreement.[24] So, for example, banks may agree to take a more reduced share of what is owed them if they get the money sooner than the others. The restructuring agreement is binding on all parties involved, including those minority of creditors who voted against it. The legal consequences of the agreement include the following (Art. 34):

- The disposition of all asset titles to the supervision committee as outlined in the restructuring agreement
- The removal of all existing preventive measures except the ones related to the national tax department (DIAN)
- The suspension of all legal processes against the territorial entity
- The suspension of the eligibility of all charges and guarantees during the term of the agreement
- Holders of fiduciary guarantees derived from real estate or mortgages must accept the substitution, if they did not exercise their claims to real property at the beginning of the process

- The territorial entity cannot borrow without explicit MFPC authorization, as established in Law 358 (all entities in 550 status would fall into the red light category under 358, at least initially) and reinforced in Laws 617 and 319.

Restructuring agreements can be modified by an absolute majority of voting shares, for instance, if the macroeconomic environment changes considerably or if liabilities are found that were not addressed in the original agreement.

Termination of Law 550 agreement. The restructuring agreement ends (without voting by the creditors) when the date is reached that was agreed upon or when the obligations in the agreement have been fulfilled (Art. 35). If the fiscal position of the SNG improves more rapidly, due to, say, an export-led economic boom, the SNG is not obliged to accelerate payment, but rather may pay only at the minimum required pace per the agreement and thus prolong its stay in the shelter of Law 550. Other events that can trigger the end are a failure by the concerned entity to adhere to the agreement or a finding by the supervisory committee that unforeseen circumstances render the agreement impossible. Nonpayment of liabilities after the initiation of the negotiations or serious misconduct by the subnational entity can also lead to a suspension of the agreement, if a majority of the creditors approve the suspension. Suspension of the 550 agreement means, in practice, that claimants can fall back on judicial orders that allow them to embargo transfers from the central government, which not only disrupts local service delivery but would typically alter the shares going to each creditor.

Insolvency proceedings for decentralized service providers. Law 550/1999 covers only the parts of the "decentralized service delivery sector" (entidades descentralizadas del nivel territorial) that are not overseen by any sectoral superintendency.[25] The institutions outside Law 550 include private and public health providers, organizations that manage funds from the General System of Social Security for Health, and providers of other public services. In insolvency cases of such entities, the concerned superintendency takes possession of the entity to ensure that the social services continue to be provided. If this is not possible, it orders the liquidation of the entity. Depending on the superintendency in charge of the sector, different laws and decrees regulate the details (see table 5.9), but the proceedings are similar.

Table 5.9 Colombian Superintendencies

Responsible superintendent	Sectors	Laws and decrees
Financial Superintendency (*Superindencia Bancaria*)	• Banking, insurance, etc.	• Articles 72 and 73 of Decree 4327/2005
National Health Superintendency (*Superintendencia de Salud*)	• General System of Social Security for Health • Entities that provide monopolistic services in the health sector	• Article 42, 42.8 of Law 715/2001 • Number 5 of article 68 of Law 715/2001 • Number 5 of article 37 of Law 1122/2007 • Number 13 of article 8 of Decree 1018/2007
Public Services Superintendency (*Superintendencia de Servicios Públicos Domiciliarios*)	• Providers of public services in water, sewerage, electricity, fuel gas, basic public telephone distribution, mobile in rural areas, etc.[26]	• Art. 121 of Law 142/1994 Same liquidation proceedings as for financial institutions Law 812
Economy Superintendency *(Superintendencia de Economía)*	• Financial Cooperatives • Saving and Credit Cooperatives • Cooperatives that provide saving and credit services	• Decree 756/2000, Decree 2206/1998, Decree 1401/1999

Source: Based on author's fieldwork.

Insolvency Procedures: Implementation and Effects

Implementation of Insolvency Procedures

From 1999, when Law 550 was enacted, to 2010, 94 territorial entities—13 departments, 7 capital cities, and 74 municipalities (not capitals)—have restructured total claims worth 5.246 billion pesos (approximately 1.23 percent of GDP) (table 5.10).[27] Twelve percent of these claims had been eliminated in the clean-up and reconciliation process (*depuración*). Fifty percent of the principal of these claims was reduced through negotiation or has been paid off,[28] leaving a balance of 38 percent. Besides restructuring, SNGs also used the possibility of prepaying domestic debt using the funds from the Oil Saving and Stabilization Fund (Fondo de Ahorro y Estabilización Petrolera).[29] DAF estimates show that almost 900 billion pesos have been prepaid using these funds.

During the same implementation period, 94 subnational entities entered Law 550 protection, of which 53 were carrying out debt restructuring agreements; 31 had successfully completed restructuring; 4 had attempted restructuring but did not reach agreement; and 6 had failed

Table 5.10 Total Debt Restructured under Law 550, 1999–2010
thousands of millions of Colombian pesos

Entity	Total claims	% of total claims	Depuración[a]	Reduction in principal[b]	Balance	% of total debt
Departments	2,414	46	88	1,139	1,187	59
Capital municipalities	1,635	31	257	823	555	28
Municipalities	1,197	23	259	674	264	13
Total	5,246	100	604	2,636	2,006	100

Source: DAF, MFPC: Informe sobre la Viabilidad Fiscal de los Departamentos, Vigencia 2010.
a. Depuración is the process of refining the list of claims.
b. Combination of payoffs and negotiated capital reductions.

Table 5.11 Entities Restructured under Law 550, 1999–2010

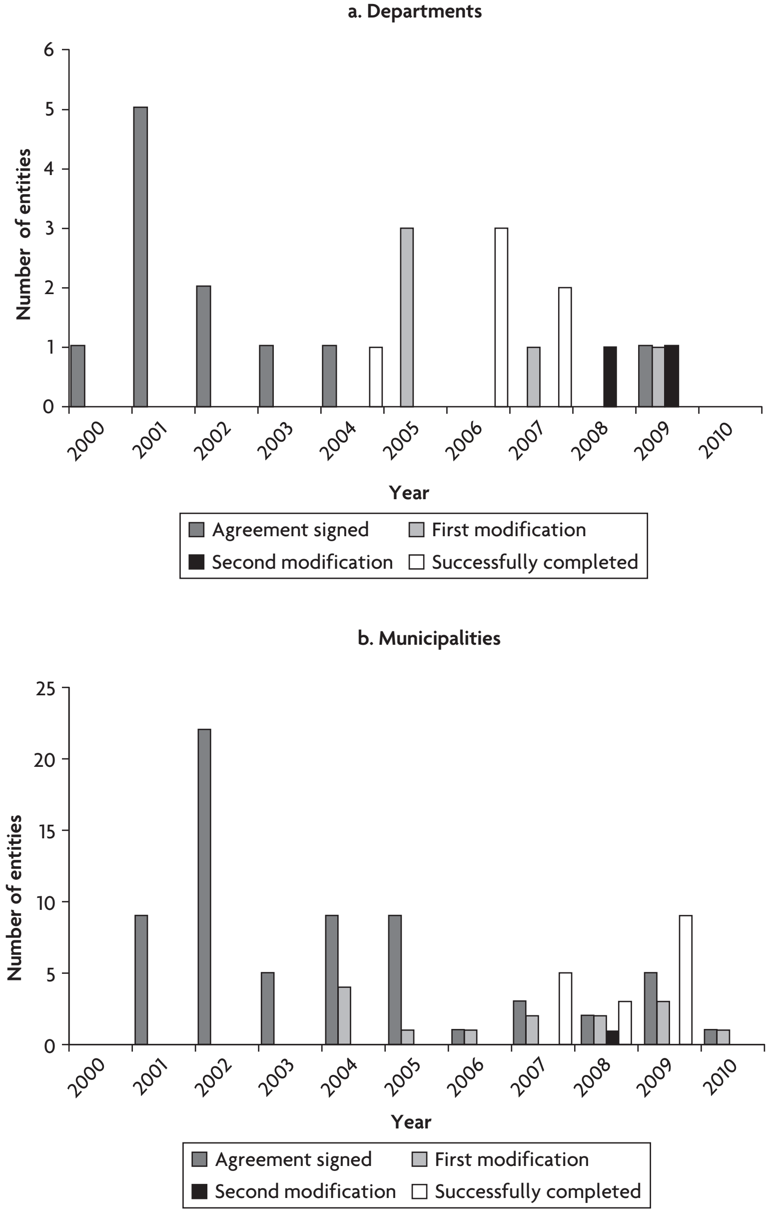
Law 550	Departments	Municipalities	Total
Restructuring under way[a]	7	46	53
Restructuring completed[b]	5	26	31
Agreement attempted[c]	0	4	4
Agreement failed[d]	1	5	6
Total	13	81	94

Source: DAF, MFPC, December 2010.
a. Departments: Cordoba, Narino, Putumayo, Sucre, Bolivar, Magdalena, and San Andres; Municipalities: Achi, Codazzi, Ambalema, Aracataca, Armero, Ayapel, Barranquilla, Canalete, Casabianca, Cerete, Cienaga, Dagua, El Molina, Fundacion, Galeras, Guaranda, Herveo, Honda, Isnos, La Jagua, Libano, Lorica, Magangue, Majagual, Monteria, Novita, Nuqui, Patia, Planeta Rica, Pradera, Puerto Libertador, Sabanalarga, Salamina, San Benito Abad, San Juan de Uraba, San Pelayo, Santa Ana, Santa Marta, Since, Soledad, Tumaco, Tamesis, Turbo, Valencia, and Zaragoza.
b. Departments: Amazonas, Cauca, Guainia, Tolima, and Vichada; Municipalities: Astrea, Becerril, Buenaventura, Cartago, Belen de los Andaquies, Caucacia, Condoto, Cordoba, Distraccion, El Reten, Fonseca, Inirida, La Paz, Lerida, Leticia, Maicao, Mariquita, Palmira, Pamplona, Popayan, Providencia, Riohacha, Rovira, Sandona, Tolu, Toluviejo, and Villanueva.
c. Puerto Rico, Corozal, Guapi, and Mocoa.
d. Agreement failed due to noncompliance: Department of Choco; Municipalities: Bahia Solano, Istmina, Malambo, Plato, and Tado.

due to noncompliance, mainly due to corruption and weak capacity (table 5.11). Also, the inability to obtain a majority of claimants who would vote for an agreement led to the failure of 3 agreements and 4 modifications to agreements. These 94 entities comprised 13 departments (with 24 percent of the total population) and 81 municipalities (with 15 percent of the total population).[30]

Figure 5.5 shows the frequency per year of insolvency debt restructuring agreements under Law 550 since they started in 2000. Most debt

Figure 5.5 Departments and Municipalities under Debt Restructuring Agreement, 1999–2010



Source: DAF, MFPC: Informe sobre la Viabilidad Fiscal de los Departamentos, Vigencia 2010.

restructuring took place in the early 2000s. The agreements were modified by 5 departments and 14 municipalities. Three agreements went through modifications twice.

There are wide differences among the nature of the claimants, differences in their legitimacy, and different legal treatments for each, as explained above. Outcomes are unpredictable because some claimants (usually not registered as financial creditors) often appear with inflated claims, and the outcomes depend on the extent to which these claims are recognized. The entire array of claims is often not well known in advance. Some claims are often reduced in the purification process—such as arrears in wages and pensions—but then the recognized claims of employees are paid in full, as required by law, and on a schedule over time. Financial sector claims are typically better documented, so they are likely to survive intact through the purification process, but then those creditors usually take a haircut on principal or interest in the restructuring process. The timing of payment is part of the negotiations, and the financial creditors usually give up some principal or reduce interest rates in order to clarify their losses and to receive some money sooner.

Implementation of Law 550 in the beginning phase in 2000 was assisted by Law 617, which facilitated the implementation of Law 550 and provided an alternate route to debt restructuring for insolvent subnational debtors. A subnational debtor would qualify for central government guarantee for debt restructuring, under Law 550, when meeting certain conditions. If a subnational debtor (a) entered Law 550 during the first six months of 2000, (b) produced a fiscal program approved by the DAF, (c) got the creditors to agree to a restructuring plan, and (d) was on schedule in payment to tax authorities, then MFPC would guarantee 40 percent of the restructured debt.

Another aspect of Law 617 was available during the same six-month window: the central government offered a 100 percent guarantee of new loans to finance adjustments such as retrenchment of workers as part of the fiscal plan to bring the entity within the spending limits set in Law 617. Also, the central government offered a 40 percent guarantee to entities for their adjustment lending from commercial banks or international development banks—that is, restructured debt (see tables 5.10 and 5.11). This support, based on decisions by the DAF, was crucial for a successful workout under Law 550, because Law 550 only stops the immediate squeeze from claimants, but it does not give the entity fiscal space with which to make investments and reforms that could restore long-term fiscal viability.

Subnational entities have benefited from the assistance of Law 617 with total restructured debt at 1,822 billion pesos. Sixty percent of the restructured debt had a 40 percent guarantee from the center, and 19 percent had a 100 percent guarantee.

Although Law 550 restructures the debt of insolvent subnational debtors, it cannot address the root course of insolvency, because Law 550 cannot force subnational debtors to undergo fiscal adjustment. In this respect, Law 617 supports Law 358 by providing a fiscal adjustment framework to ensure the effectiveness of ex-ante fiscal rules as defined by Law 358. Law 617 also supports Law 550 by providing central government assistance in fiscal adjustment so that the debt restructuring can lead to a realistic and sustainable path. Table 5.12 summarizes the number of entities with fiscal adjustment programs under Law 617, Law 358, or both, under the supervision of the DAF.[31]

Effects of Insolvency Procedures

Given the lender-borrower nexus and various channels that would influence government fiscal deficits and indebtedness, it would be difficult to precisely separate and measure the effects of each individual law that aims at enforcing fiscal discipline (Liu and Webb 2011).[32] The evaluation of the insolvency proceedings must be within the broader context of fiscal reforms. Law 550 does not operate in a vacuum. As shown, the insolvency proceedings in Colombia followed a series of reforms including the traffic light law in 1997, and was assisted by parallel or follow-up legislation, such as Law 617, which helps the fiscal adjustment process.

Other factors have been in play. Colombia has enjoyed solid economic growth and macroeconomic performance from 2003 onward. Compared with the annual average growth of 1.6 percent from 1997 to 2002, real GDP accelerated to almost 5.9 percent from 2003 to 2007. The global financial crisis has impacted the Colombian economy, but the economy still grew at 4.5 percent from 2008 to 2010, on average, and benefited from higher commodity prices, which increased royalty income from coal and oil. Inflation, which was in the double digits from 1997 to 2002, was reduced to an annual average of 4.5 percent from 2003

Table 5.12 Entities under Law 617 and/or Law 358, 1997–2010

Law 617 and Law 358	Departments	Municipalities	Total
Restructuring under way[a]	3	2	5
Restructuring completed[b]	1	28	29
Agreement failed[c]	0	1	1
Total	4	31	35

Source: DAF, MFPC, December 2010.

a. Departments: Atlantico, Guajira, and Valle del Cauca; Municipalities: Cali and Corozal.

b. Departament: Santander; Municipalities: Bello, Cajamarca, Caramanta, Cartagena, Charalá, Chinchiná, El Copey, Espinal, Filandia, Girardota, Guacarí, Guamo, Ibagué, Icononzo, Jamundí, Maria la Baja, Pacho, Palestina, Piedecuesta, Rionegro, San Diego, San Gil, Villa María, and Villarica, under 617; and Manizales, Fresno, Roldanillo, and Santa Isabel, under 358.

c. Quibdo, capital of Choco, did not complete the performance agreement.

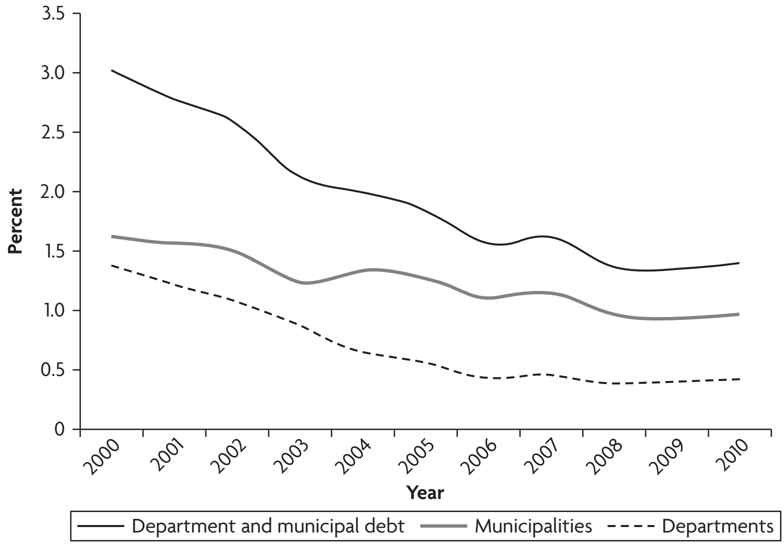
to 2007. Monetary policy has helped maintain an internal balance, since inflation outcomes remained within the targeted range of 2–4 percent. Although the fiscal deficit of the combined public sector rose from 2.7 to 3.2 percent of GDP during 2009–10, mainly due to lower oil-related revenues, public debt sustainability is not a major concern in the medium term.[33] The combined public sector debt-to-GDP ratio is projected to decline from 36.4 percent in 2010 to 31.2 percent in 2016. All three major rating agencies upgraded Colombia to investment grade in 2011.

Notwithstanding the challenges in analyzing the precise contribution of fiscal legislation and regulatory reforms, to the extent that these reforms intend to improve government finance and avoid overindebtedness, it is worthwhile ascertaining whether this legislation has been associated with improved fiscal outcomes (Liu and Webb 2011). Overall, the subnationals' debt has declined as a share of GDP since the peak of 1999, their revenues have strengthened, and their credit ratings have improved.

Subnational debt as a share of GDP has declined since its peak—from almost 8 percent in 2000 to approximately 4.5 percent in 2010—one of the lowest levels in the last 20 years. Looking more closely, the decline in debt as a share of GDP has happened for not only the decentralized service entities, as shown in figure 5.3, but also for departments and municipalities, as shown in figure 5.6.

SNG total revenues increased from 7.6 to 10.4 percent of GDP between 2000 and 2010 as a result of economic growth; improved revenue collection; and increases in transfers, which accounted for most of the revenue increase.[34] The rating of subnational debt improved,

Figure 5.6 Department and Municipality Debt Balance as Percentage of GDP, 2000–10



Source: NPD, Desempeño Fiscal de los departamentos y municipios, 2010.
Note: Decentralized service entities are not included in the figure to show only subnational government debt. GDP = gross domestic product.

because the share of debt that qualified as being served and as posing little risk (an A rating) increased from 35 percent in 2000 to 90 percent in 2010 for departments and from 49 to 78 percent for municipalities.[35]

For those subnational officials in office when the fiscal problems originated, the political and fiscal consequences are largely moot, since mayors and governors cannot be reelected and are thus usually out of office by the time the insolvency crisis must be worked out. Nonetheless, the governments and parties in power suffer the stigma of bankruptcy if they go through a 550 process, which may hurt them in the next election. A government's performance in office correlates somewhat with election chances of associated candidates. Thus, electoral incentives exist, albeit weakly, for officials to show good fiscal performance.[36]

There have been a few clear failures of the insolvency process, mostly municipalities, and the fiscal problems in those places stem from severe governance problems—guerillas, narcotraffickers, and so forth—that go deeper than overborrowing and fiscal irresponsibility. Neither Law 550 nor other parts of the SNG fiscal regulatory regime could have solved those problems.[37]

The most important sanction for subnational officials who do not comply with the terms of a 550 agreement is that fiscal resources are withheld, since claimants can again get court-ordered embargoes. A more complete loss of resources under local control occurs when the national government authorities use Decree 28, since 2008, to take over the fiscal and other resources of a sector because the SNG has failed to deliver critical social services.[38]

Implementation of Law 550 has succeeded in many ways. The process is transparent and follows the procedures as prescribed by the law. There have been two unpredicted effects—some agreements take a long time to finalize, and some SNGs remain in the 550 regime even after they have become fiscally creditworthy again.

Although many SNGs signed 550 agreements almost a decade ago, fewer than half have fully paid off their debt since the restructuring agreements were signed. Most of the SNGs are fulfilling their debt restructuring agreements, although some are struggling financially. Some subnationals have strengthened their finances sufficiently so that they prepay their obligations and exit the 550 regime ahead of schedule, but they prefer to simply pay on schedule and keep the 550 protection against judicial embargoes.[39] Some of the embargoes have legitimate origins, but others arise from collusions and schemes to obtain public funds for private purposes. They have caused serious disruption for many subnationals, and some SNGs have used Law 550 as a way to block the embargoes.[40]

In judicial embargoes, a judge has no option but to apply the law, and in individual enforcement, the judge needs to enforce the presented claim, not the other claims. One problem lies in the possibility that assets belonging to public institutions are available for individual enforcement of private claims. One potential solution could be to avoid enforceability, and the judge instead would notify the administrative authorities and would trigger an "alarm" system, eventually forcing the public institution to initiate a restructuring proceeding.

Summary and Conclusions

The protection offered by bankruptcy Law 550 enables insolvent SNGs to reach orderly debt restructuring agreements with creditors, since the other laws aiming at ex-ante control cannot eliminate the risks of bankruptcy. Courts dealing with individual case-by-case claims are not set up to solve the problems of competing claims against insolvent subnational debtors. Corruption in some of Colombia's local courts exacerbate the problem, but even without the corruption issue, if a case were not under a bankruptcy law, courts would have to act on claims in the order the claimants came to the court, rather than the seniority order of claims.

The factors leading to insolvency changed over time in Colombia, and therefore the clientele and effects of the law changed. During 2000–02, most departments and larger municipalities going into 550 had had access to credit markets in the 1990s and overborrowed. The successful 550 processes for them led to restoration of market access, and new laws after 2000 regulated SNG borrowing, so that both lenders and SNGs became more cautious and overborrowing rarely occurred. After 2003, the new insolvency cases entering the 550 process were mostly municipalities, and mainly resulted from (nondebt service) arrears and the subsequent penalties and interest.

Law 550 focuses on workouts from bankruptcy and has limited ability to address the root causes of fiscal stress and debt. Other complementary laws—mainly Laws 358, 617, and 819—work in several ways by (a) limiting borrowing, (b) promoting fiscal transparency, (c) strengthening the budgetary process, and (d) helping to finance debt restructuring. Although Law 550 does nothing to address governance issues directly, it has helped create fiscal space for some newly elected governments with insolvent situations to have a fresh start and carry through reforms.

A unique feature of the Colombia case is the use of an administrative apparatus to deal with insolvency. The SOC, a venerable administrative agency in Colombia, fills the role that bankruptcy courts do in some countries. This agency was designated in the Bankruptcy Law, rather than the courts, which have historically been weak and are sometimes complicit in pushing claims that lead to bankruptcy. The Ministry of Finance, through its DAF, works closely with the insolvent SNGs and with the SOC to resolve the insolvency cases. Despite the country-specific institutional setup, the results of the insolvency process in Colombia are similar to the results elsewhere.

Macroeconomic fundamentals matter for the success of insolvency procedures. The implementation of Law 550 and other fiscal legislation has taken place in the context of improving the macroeconomic performance of the country since 2003. Colombia's key macroeconomic indicators, such as GDP and inflation, have remained relatively strong even after the global financial crisis of 2008–09. This helped the turnaround of the fiscal balance through higher revenues and moderate interest rates. The reform in the intergovernmental fiscal transfers system also played a positive role in stabilizing central government transfers to SNGs.

Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

1. In the Colombian system, all insolvency processes are administrative; there is no intervention of judges in normal insolvency procedures.
2. For a review of these country experiences, see Liu and Waibel (2009) for a review of cross-country experience, chapter 7 by Jókay (2103) for Hungary and chapter 8 by De Angelis and Tian (2013) for the United States in this volume. Not all local governments are allowed to use the federal court for Chapter 9 filing in the United States, since some states do not give authorization for their local governments for filing in the federal court. See chapter 14 by Liu, Tian, and Wallis (2013) in this volume for a review of how 50 states handle local government insolvency in the United States.
3. Subnational insolvency was added to the jurisdiction of the SOC through Law 550 in 1999. The SOC was started in the 1930s, and it is an institution with multiple functions as a company registry, a company supervisor, and an insolvency regulator with quasi-judicial functions.
4. This section draws on chapter 1 of MFPC (2009).
5. Law 33/1968 and 46/1971 implemented the constitutional mandate through formulas for revenue sharing of funds earmarked for specific sectors, mostly education and health.
6. Such as water utilities, construction of health and education facilities, agricultural technical assistance, urban development and transport, and other local infrastructure.
7. The term *territorial governments* is used in Colombia and means the same thing as *subnational governments*.
8. Data: National Statistics Administrative Department (Departamento Administrativo Nacional de Estadística, http://www.dane.gov.co/#twoj_fragment1-4MFPC: Balance Fiscal Gobierno Nacional Central 1994–2010. The SNG share in spending excluded spending by decentralized entities (mainly infrastructure companies owned by SNGs).

9. Education and health account for about 41 percent of spending by departments and 45 percent by municipalities (World Bank 2009).
10. Including the Situado Fiscal and the Participaciones Municipales.
11. Initially, there was a danger that the specified real growth of transfers would outpace the (perhaps negative) growth of real GDP and revenues, as happened in Argentina during 1999–2001, but fortunately Colombia's real growth turned increasingly positive (see Gonzalez, Rosenblatt, and Webb 2004).
12. The last revision to the GTS under Law 1176/2007 slightly modified the distribution system and defined the amounts over the medium term.
13. See World Bank (2009), tables 1.1C and 1.2C for details.
14. Subnational Development Financial Entity (Financiera de Desarrollo Territorial, SA, FINDETER), whose responsibilities are rediscount credits from subnational entities and its decentralized entities, metropolitan areas, municipality entities or associations, among other financial services; http://www.findeter.gov.co/aymsite/index_en.php. Institutes for Territorial Promotion and Development (Institutos de Fomento y Desarrollo Territorial, INFIS) are financial institutions not overseen by the Financial Superintendency. See Duff and Phelps de Colombia SA, Finanzas Territoriales, Special Report, April 2009.
15. These three companies are TGI International Ltd., Bogotá Electricity Company, and Medellin Public Enterprises. *Source:* Bloomberg.
16. MFPC 2009, 28.
17. Operational savings is defined as the difference between current income and noninterest expenditures.
18. Art. 15 establishes a transition period after the law becomes effective during which entities with both indicators above the critical indebtedness threshold would be able to increase their net debt up to 60 and 40 percent of the Consumer Price Index for the first and second year, respectively.
19. Districts and municipalities that are capitals of departments must obtain permission from the MFPC.
20. Law 550/1999, Art. 58 and modifications to Law 617/2000 Art. 69.
21. Insolvency proceedings for private companies are now regulated by Law 1116/2006 (and modifications introduced by Law 1173/2007 and Law 1380/2010).
22. Art. 17 and Art. 3 of Decree 694/2000. Subnational entities are forbidden from taking the following actions: (a) incurring new debt or other liabilities; (b) modifying labor contracts or hiring new staff; (c) modifying the budget or starting projects that incur substantial expenditures; (d) buying or selling assets; (e) fulfilling guarantees; and (f) compensating, paying, or clearing any obligations except the ones that are strictly necessary to avoid paralysis of the basic service provision or that affect fundamental rights.
23. The votes are weighted by the share of each claimant in the total liability, as determined by the promoter and the SOC. The pension claimants choose a spokesperson who has a unified vote for them as a group. Law 549 (1999) provides further details on defining pension liabilities.

24. Pension funds arrears are often overstated, sometimes unintentionally, because workers often switch pension funds, but the old fund does not know this and sees only missed payments to its client accounts (based on mission interview in October 2010 with a lawyer for pension funds).
25. Law 550/1999, Art 58 (1) and modifications in Law 617/2000 Art. 69.
26. Services related to telecommunications such as telephone distribution and local mobile service in rural areas are no longer regulated by the Superintendency of Public Services, but by the Telecommunications and Information Technology Law 1341 of 2009.
27. The total claims are calculated by adding the claims recognized by subnational debtors and the additional claims brought by creditors.
28. Payments done by the territorial entities.
29. This was under Law 633/2000, which regulates the Oil Saving and Stabilization Fund.
30. In addition to departments and municipalities, four entities had also used Law 550 during the same period. These entities are hospitals under the Cesar Department (Universidad del Atlántico and ESE Hospital Olaya Herrera de Gamarra, ESE Hospital Regional Jose Villafañe de Aguachica, and ESE Hospital Inmaculada Concepción de Chimichagua).
31. A case study of Nariño, a department at the south end of the Pacific coast, shows that Nariño benefited from MFPC support under both Law 550 and Law 617. Indeed, it seems to be a classic case of using these two programs, in the sense that it needed both the bankruptcy protection of Law 550 and the structural adjustment supported by 617. The downsizing of personnel is especially important to Nariño's fiscal adjustment. Nariño is a successful example of implementing debt restructuring under Law 550. The implementation started without errors and there was apparently no delay or backsliding in implementation. No second debt restructuring was needed. Nariño is on track to exit from the 550 bankruptcy process as originally scheduled. (Based on authors' 2010 fieldwork.)
32. Corbacho and Schwartz (2007) discuss the problems of determining the direction of causality. Their study compared national fiscal deficits in countries with and without Fiscal Responsibility Laws, and found that the former had smaller deficits. Data on subnational deficits for such cross-country comparisons, however, are not readily available.
33. A Debt Sustainability Analysis, prepared by International Monetary Fund staff (in the context of the 2011 Article IV Consultation), indicates that the trajectory of public debt is declining in the baseline scenario.
34. Central Bank (Banco de la República), http://www.banrep.gov.co/series-estadisticas/see_finanzas_publi.htm; IMF - Colombia - Data and Statistics.
35. Source: DAF, MFPC, "Informe sobre la Viabilidad Fiscal de los Departamentos," Vigencia 2010.
36. In 2008, a new government in Barranquilla formulated an ambitious plan for debt restructuring and economic development. The agreement under Law 550

was revised a third time at the end of 2008. It also got new lending under Law 617 to finance administrative reform, with the lending and refinancing backed by a central government guarantee. In 2010, Barranquilla was able to access the financial markets without government guarantee. It was the first SNG entity to get new market financing while still under 550 protection. Combined with the substantial fiscal adjustment for spending and own revenue, Law 550 protection actually improved Barranquilla's creditworthiness. (The information on Barranquilla is based on 2010 fieldwork.)

37. The department of Chocó and other Pacific departments and the Amazonian region share the common challenge of flourishing illegal armed forces. The impact of central-government-led efforts in promoting fiscal and debt management in Chocó has been reduced due to the governance-related challenges such as the absence of the rule of law and of a national political culture (Shepherd 2009).
38. The department of Chocó and some small municipalities with very weak management capacity (and often much corruption and violence) have fallen into such situations and exist largely only as entities on paper, without substantive roles, since the central government departments manage the social service spending (Shepherd 2009).
39. Based on discussions with the authorities during October 2010 and July 2011. For instance, this was the case for Barranquilla; in 2010, it got a good credit rating and returned to the financial markets for fresh lending, although it was still under 550 protection.
40. Based on field interviews during 2011. Law 550 may not protect SNGs against all embargos. In the case of St. Marta, several court orders led to an embargo of up to 25 percent of annual own revenues. Meanwhile, the district did have an agreement under Law 550. But the 550 order was not respected and the embargoed funds got first priority.

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6

France's Subnational Insolvency Framework

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Introduction

France had a long tradition as a centralized state. However, two waves of decentralization laws—during 1982–83 and 2003–04—contributed to devolving more powers to the three types of subnational governments (SNGs): municipalities, departments, and regions. SNGs in France now have administrative autonomy, own responsibilities, executive powers and, since 2003, financial autonomy. Because there are a large number of small municipalities in France, intermunicipal cooperation arrangements are common, covering a range of services such as water supply, household waste collection, and sewerage. In addition, SNGs may own 50–85 percent of joint public-private partnerships (*sociétés d'économie mixte locales*, SEMs).

Before 1982, the state controlled all the loans made to SNGs, usually at favorable interest rates. With the 1982 Decentralization Act, SNG access to borrowing was no longer submitted for approval of the Prefect (the representative of the state in each department). The monopoly status of public financial institutions ended in the 1980s, and since then, the credit market for SNGs has consisted mainly of a few banks. Since the 2008–09 global financial crisis, interest in the development of a subnational bond market has grown.

After some municipalities experienced severe financial distress in the first half of the 1990s, the central government tightened the regulatory framework for SNG borrowing and introduced greater disclosure and transparency. Prudential rules are now used to monitor debt, liquidity, and contingent liabilities. In addition to the borrowing framework, SNGs must also follow accounting and budget rules. Although SNGs have considerable fiscal autonomy, the state exercises strong supervision and monitoring of SNG financial accounts through three institutions: the Prefects, the Regional Chambers of Accounts (*Chambres Régionales des Comptes*), and Public Accountants.

By law, SNGs cannot declare bankruptcy, and public assets cannot be pledged as collateral. If SNGs become insolvent, the central government intervenes, enforcing fiscal adjustment and facilitating debt negotiations among creditors and the borrower. The central government does not guarantee SNG borrowing but may provide exceptional financial assistance. However, the amount of assistance by the central government is extremely small, and there is no expectation of a state bailout.

SEMs are subject to standard corporate insolvency law. Other government-owned entities, such as *établissements publics* (public establishments), which are financially autonomous agencies, are as a general rule subject to administrative law. In such cases, liquidation is not an option.

This chapter reviews how the French system combines decentralized responsibilities and fiscal decisions with fiscal monitoring from the central government and how central monitoring, supervision, and intervention deals with SNG insolvency. As part of this volume that reviews and shares country experiences in managing subnational debt and related regulatory reforms, this chapter covers up to 2010.[1]

The rest of the chapter is organized as follows. Section two reviews SNG institutional structures and finances. Section three focuses on three channels of control and monitoring of SNGs by the central government. Section four presents the subnational borrowing framework and the evolution of subnational credit markets. Section five discusses contingent fiscal risks arising from various forms of intermunicipal and public-private arrangements. Section six explains how the French system resolves SNG insolvency. Section seven offers conclusions.

Institutional Structures and Finances of Subnational Governments in France

Administrative Structure

French decentralization dates back a thousand years to the emergence of France as an independent state. Municipalities (*communes*) were created relatively recently—in 1789—the year the French Revolution (*Révolution Française*) began. The departments (*départements*) were created the following year, in 1790, before becoming local authorities at the beginning of the Third Republic, owing to the first decentralization law of August 10, 1871. That law reorganized the balance of power within municipalities and provided a check on mayoral authority through town councils. Regions (*régions*) were created in 1972 and were given the status of local authorities in 1982.[2]

Before 1982, departments and municipalities had limited competences. As representatives of the central government in each department, the Prefect held the executive power and in that capacity supervised the laws passed by all SNGs and had the power to approve or cancel subnational decisions. The two waves of decentralization since the early 1980s have led to a major shift in the history of French institutions. The resulting administrative structure is summarized in figure 6.1.

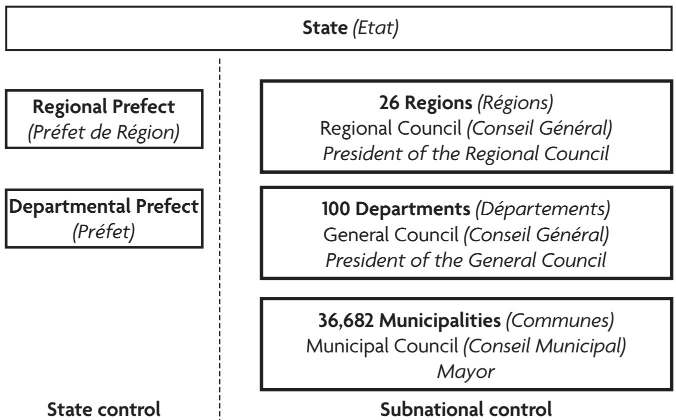
Under Title XII of the French Constitution,[3] SNGs are administrative structures—distinct from the national administration—that exercise competences within a given territory. France consists of 26 regions, 100 departments, and 36,682 municipalities, which account for 40 percent of all European SNGs. There is no hierarchy among the three levels of government, and none may exercise authority over another territorial entity.[4] Four regions and four departments have a special status.[5]

Two Waves of Decentralization

In the early 1980s, a national law was passed mandating major reform of French institutions.[6] Reforms included:

- Replacement of ex-ante prefectoral control with ex-post legal control exercised by the Prefect, the National Court of Accounts (*Cour des Comptes*), and the newly created Regional Chambers of Accounts (RCA), in charge of budgetary control of SNGs.

Figure 6.1 Subnational Governments in France



Source: Dexia 2008.

- Transfer of executive power at the departmental level to the president of the General Council (that is, the executive power in the department).

The laws of January 7, 1983, and July 22, 1983,[7] determined the respective competences of the central government and SNGs and set up the rules for transferring financial resources. These laws are now regarded as "Act I of French decentralization."

A second wave of decentralization began in 2003. Constitutional Law No. 2003-276 refers to the "decentralized organization of the Republic"[8] and mentions the regions in the Constitution.[9] The three local government levels (municipalities, departments, and regions) are considered "territorial communities" (*collectivités territoriales*). SNGs have their own executive powers and, since 2003, the Constitution recognizes their financial autonomy.[10] The Constitution also recognizes various intercommunal structures and allows for the merger of existing SNGs with larger entities.[11] The constitutional reform also enshrines direct democracy at the local level,[12] the financial autonomy of territorial entities,[13] and the governance of overseas territories.[14]

Law No. 2004-809 of August 13, 2004, on local liberties and responsibilities, devolved additional responsibilities from the central government to territorial communities starting January 1, 2005 (table 6.1).

Table 6.1 New Powers Devolved to SNGs in 2004, France

Municipalities	**Powers before 2004**	**Additional powers since 2004**
Economic and territorial development	• Local public utilities (waste collection and treatment, water distribution, sewerage) • Urban planning	• The law of August 13, 2004, did not significantly affect the responsibilities and finances of municipalities.
Social aid and health	• Social aid (childcare and kindergartens)	
Education and culture	• Construction and maintenance of primary schools	
Departments	**Powers before 2004**	**Additional powers since 2004**
Economic and territorial development	• Construction and maintenance of secondary roads • Interurban public transport	• Management of some formerly national roads and staff (since 2006)
Social aid, solidarity, and health	• Social assistance (children, disabled adults, and elderly) • Implement the minimum subsistence allowance (since 1988) as set at the national level • Preventive health care • Medical prevention	• Financial assistance for the young • Finance social funds for housing
Education and culture	• Construction and maintenance of public junior high schools	• Management of some nonteaching staff in junior high schools
Regions	**Powers before 2004**	**Additional powers since 2004**
Education	• High school construction, maintenance, and operating costs • Fund professional training • Cofund universities	• Establish education requirements • Fund schools • Management of nonteaching staff in high schools (since 2006)
Economic, territorial development, and transport	• Organize and finance regional passenger rail services • Responsibility for infrastructure • Allocation of subsidies (business tax exemption)	• Transfer of private-sector economic aid to regions • Formulate regional plans for economic distribution
Culture	• Organization and financing of regional museums	• Responsibility to compile inventory of cultural patrimony
Health	n.a.	• Health care education services (prevention actions, vaccination, etc.) Possibility of financing sanitary facilities

Source: Fitch Ratings 2008a.
Note: n.a. = not applicable.

The two waves of decentralization changed not only the structure and responsibilities of SNGs, but also central government oversight and control. Departments and regions received additional responsibilities and resources, mainly through greater tax-raising power, and administrative autonomy (Fitch Ratings 2008a).

The Importance of Inter-SNG Entities and SNG-Owned Firms

Compared to other countries, France has a large number of tiny municipalities, with an average population of just over 1,600. More than 20,000 municipalities have fewer than 500 inhabitants, and 32,000 municipalities have less than 2,000 inhabitants.[15] Intermunicipal cooperation began in the late 19th century to overcome fragmented services of small SNGs. Since then, many cooperative legal structures (*établissements publics de coopération intercommunale*) have often been established across municipal boundaries to carry out responsibilities more efficiently.

There are two major types of intermunicipal cooperation structures: (a) structures without own-source tax revenue, that is, single-purpose structures (*syndicats de communes à vocation unique*) and multipurpose structures (*syndicats de communes à vocation multiple*); and (b) large intermunicipal structures that can levy their own taxes (for example, a local business tax).

Three types of municipal cooperation with own-source tax revenue were created in 1999. They are (a) *communautés de communes* (associations of villages, by small towns), (b) *communautés d'agglomérations* (associations of towns) for medium-size urban areas of 50,000–500,000 inhabitants with at least one city with a minimum of 15,000 inhabitants), and (c) *communautés urbaines* (urban communities with at least 500,000 inhabitants).[16]

In 2008, 91 percent of French municipalities, accounting for 87 percent of the population, belonged to at least one of the 2,583 intermunicipal cooperation structures with own-source tax revenue. These structures are funded through taxes they levy and grants from the central government.[17] Intermunicipal cooperation structures have a deliberative body made up of elected counselors from the participating municipalities, an executive, and a committee. The intermunicipal structures delegate a growing share of the service delivery functions to the three main types of public entities they own or over which they exercise control.

The first type of public entity is SEMs—public-private partnerships—which are commercial companies subject to the corporate insolvency law[18] and commercial laws. The delegation of powers to SEMs often concerns infrastructure service delivery, such as public transport. SNGs must own between 50 and 85 percent of the capital. If an SEM finds itself in financial distress, its "public" assets are typically transferred to a new entity that continues its public service function, a procedure that is sometimes used for privately owned companies. SNGs bear the losses of SEMs as shareholders and may be liable under implicit or explicit guarantees. Although the SNG is the majority shareholder, oversight by subnational deliberative bodies is sometimes weak.

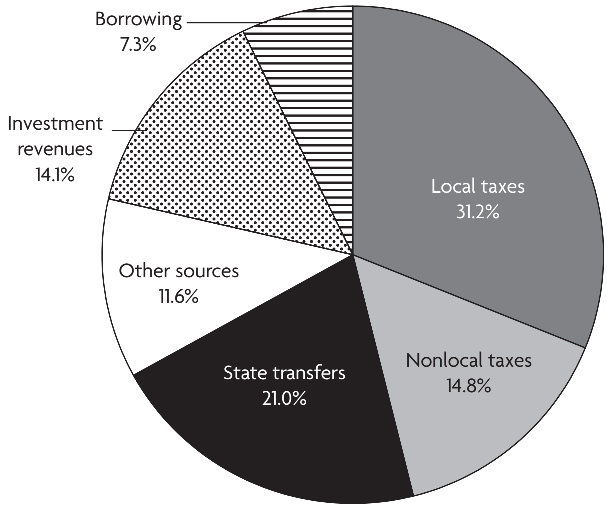
The second type of public entity is public establishments (*établissements publics*)—financially autonomous agencies subject to administrative law. Public establishments are mainly created in the health, education, and cultural sectors. Despite their relative autonomy, public establishments are controlled by SNGs. As entities governed by public law, they cannot be liquidated.[19] The largest public establishments are supervised by the central government.

The third type of public entity is the nonprofit association, which often receives grants from subnational administrations. Elected officials generally hold key posts in these associations. This kind of collaboration could pose fiscal risks for the local government, since the local government may have to help close the fiscal deficits of associations that are deemed to be essential for social cohesion.

Structure of Subnational Finances

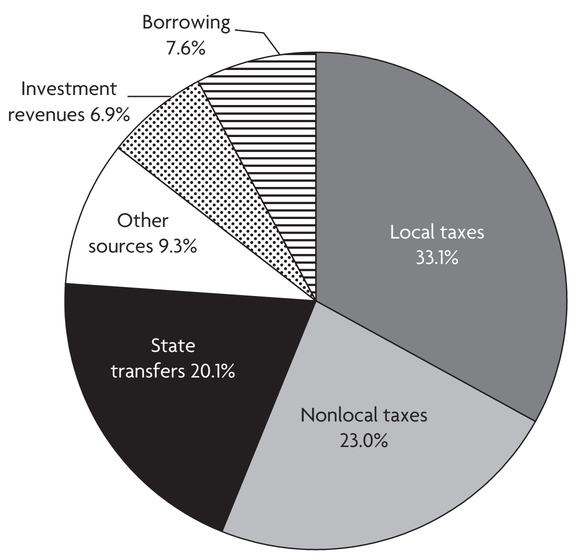
In 2009, SNG expenditures in France amounted to €214 billion, which represented 21 percent of total public expenditures.[20] On average, municipalities accounted for about 49 percent of SNG expenditures, departments for 36 percent, and regions for 15 percent.[21] Tax revenues accounted for about 49 percent of SNG total revenues. Financial transfers from the central government to SNGs accounted for about 21 percent for municipalities and departments and 31 percent for regions. Borrowing accounted for less than 10 percent of SNG total revenue (figures 6.2, 6.3, and 6.4).

Figure 6.2 Sources of Municipal Revenues in France



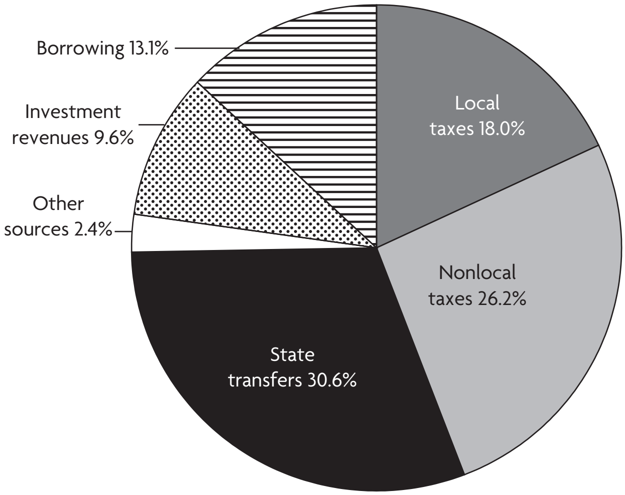
Source: General Directorate of Subnational Entities (*Direction Générale des Collectivités Locales*, DGCL) 2011.
Note: The latest data from DGCL 2011 are 2009 figures.

Figure 6.3 Sources of Departmental Revenues in France



Source: DGCL 2011.
Note: The latest data from DGCL 2011 are 2009 figures.

Figure 6.4 Sources of Regional Revenues in France



Source: DGCL 2011.
Note: The latest data from DGCL 2011 are 2009 figures.

SNGs have three main kinds of revenues: state transfers (about €72 billion in 2008) (Fitch Ratings 2008a), local taxes, and shared taxes (nonlocal taxes). The four local taxes are as follows:

- The residential tax, based on the rental value of property (*taxe d'habitation*)
- The building tax (*taxe sur le foncier bâti*)
- The land tax (*taxe sur le foncier non-bâti)*
- The business tax paid by owners (companies and individuals) and by companies based on fixed-asset rental value and on payroll (*taxe professionnelle*) (Rapport Balladur 2009).[22]

The shared taxes are (a) the oil tax (*taxe intérieure sur les produits pétroliers*), (b) the tax on insurance contracts, (c) the tax on real estate transactions, and (d) the vehicle registration tax. The transfers from the central government are mainly composed of the *Dotation Globale de Fonctionnement* (General Public Service Grant), which is nonearmarked.

The 2008–09 global financial crisis weakened the financial position of French SNGs. Although the impact has been mitigated by the central government's stimulus package (Fitch Ratings 2009),[23] the sustainability of SNG fiscal positions, in view of the uncertainty in the global recovery, remains in doubt. In April 2010, the Jamet Report (Rapport Jamet 2010) projected that 11 departments might face financial distress.[24] These departments have faced dramatic increases in social spending[25] and dramatic decreases in revenues.

Control and Monitoring by the Central Government

While there is substantial decentralization in France today, the central government continues to exercise control over SNGs through balanced budget rules for SNGs, and through three key institutions—the Prefect, the RCA, and the Public Accountants—all of which play a large role in policy making at the subnational level. The Prefect is the representative of the central government in the department and exercises general oversight of municipal activities. The RCA is responsible for controlling SNG accounts. The Public Accountants, as public servants in the central government, are responsible for ensuring the regularity of SNG payments.

Balanced Budget Rules and Processes

The state supervises SNGs through balanced budget rules; that is, the budget of an SNG must be balanced. This principle is implemented through the budgetary processes; the assemblies that approve the budgets must vote budgets in which the investment section and the operating (or current) section are each balanced.[26] This equilibrium must be based on reasonable assumptions about the revenue and expenditures (real equilibrium) and must include all the compulsory expenditures including debt service.[27] Compulsory expenditures must be paid from revenues and cannot be paid from borrowed funds. Box 6.1 presents the specific rules regarding the budget processes.

The Prefect and the Regional Chamber of Accounts

The central government also exercises detailed and regular oversight to ensure that SNGs are able to meet their debt obligations.[28] This

Box 6.1 Subnational Financial Rules: Fundamental Principles, France

Following are the fundamental principles that guide subnational financial rules in France.

The Principle of Annuality: The budget is voted for the calendar year—that is, for January 1 through December 31.

The Principle of Anteriority: The budget must be voted before March 31 of the current year (or April 15 if a new territorial assembly has been elected). Decisions that modify the budget must be adopted before December 31 for investment credits and before January 21 of the following fiscal year for operating credits (article L. 1612-11 of the General Code of Territorial Entities (*Code Général des Collectivités Territoriales*, CGCT).

The Principle of Unity: A single document, comprising the whole budget, is voted on.

The Principle of Universality: All expenditures and revenues must be listed. No revenue item can be earmarked.

The Principle of Speciality: All revenues and expenditures are classified according to an accounting system.

The Principle of the Balanced Budget: The budget of municipalities, departments, and regions must be balanced when it is voted on. Both the operating and investment sections must be balanced (Article L. 1612-4 of the CGCT). Revenues must be sufficient to cover annual debt repayments, and the revenues and expenditures figures must be in good faith (that is, revenues must not be overestimated and expenditures must not be underestimated). If the SNG refuses to increase revenues to balanceexpenditures, the Prefect can impose new taxes (this procedure is called the *inscription d'office*; see the decision by the Regional Chamber of Accounts of Languedoc-Roussillon, *Commune de Bolquère*, January 18, 1989).

oversight comes in three forms: legal, budgetary, and management. The focus is on the prevention of subnational financial distress through an elaborate system of controls, including oversight by Public Accountants of all SNG disbursements. These ex-ante controls are designed to substantially reduce the probability of default.

Legal controls concern the legal validity of acts, such as compliance, respect for procedural rules, and mistakes on points of law or fact or abuse of power or procedure. In particular, assembly votes or the imposition of taxes are subject to a review of their legality. The Prefect or any affected person may appeal to the administrative judge, who has power to annul the act in whole or in part.

Budgetary control concerns the budgetary process, as prescribed by law. The deadlines for the regular (as opposed to extraordinary) budgetary process are presented in table 6.2.

Table 6.2 Deadlines for the Regular Budget Process, France

Date	Process
January 1	Beginning of the financial year
April 15	Deadline for the adoption of the draft budget
June 1	The current financial account kept by the public treasury must have been transferred to the local assembly
June 30	The current administrative account kept by the local government must have been approved by the local assembly
December 31	End of the financial year

Source: Robert 2009.

The Prefect controls the legality of the local budget ex post (Articles L. 1612-1 to L. 1612-20 of the CGCT). Article 47-2 of the French Constitution states:

> The National Court of Accounts assists Parliament in the control of the action of the government. It assists Parliament and the government in the control and execution of finance laws and the social security financing laws as well as in the evaluation of public policies. It helps to inform the electorate by publishing public reports. The public administration accounts must be regular and in good faith, and give an accurate picture of the results of their management, of their property and of their financial situation.

SNG budgetary decisions must be sent to the Prefect. The Prefect, or any other person affected by the decisions (for example, any taxpayer living in the jurisdiction of the SNG or any debtholder) can contest the legality of the decisions before the administrative tribunals within two months of their adoption. An example would be new borrowing to cover a deficit in the operating budget, which is prohibited by the budget legislation. The administrative judge has the power to nullify the decision.

The Prefect and the RCA are in charge of budgetary controls. RCAs were created by the law of March 2, 1982. Each region has its own Chamber, and all members, called magistrates, have life tenure. These courts have jurisdiction not only over SNGs, but also over public establishments (hospitals, public secondary schools, and so forth), public-private partnerships, and associations funded by SNGs. Budget decisions need to be sent to the Prefect when adopted. RCAs have the power to make adjustments to budget proposals (fiscal adjustments).

Should these proposed adjustments by the Chamber not be incorporated into the budget, the Prefect may intervene to ensure that SNGs meet their compulsory expenditures and comply with balanced budget rules. The Prefect can choose to disregard the RCA recommendations but must explain the reasons for doing so.

Budgetary control concerns only budgetary instruments in the strict sense: the draft budget, any supplementary budget, decisions to modify the existing budget, any annexed budget, and the administrative account. Control is limited to the following: (a) the dates of the vote and the submission of the initial budget, (b) the balancing of the budget, (c) the approval of the accounts, and (d) the inclusion and payment of compulsory expenditures. If a violation occurs, the Prefect refers the matter to the RCA,[29] which may then modify the budget decision.

The draft budget must be sent to the Prefect within 15 days of passage. Otherwise, the Prefect asks the RCA to intervene. In 2007 and 2008, the Chambers rendered 114 decisions on budgets, 49 of which were for missed budget deadlines (National Court of Accounts 2009c).

Regarding balancing the budget, the Prefect can refer the matter to the RCA up to one month after receiving the budget. The court has one month from that date to propose measures to the concerned SNG to balance the budget. The Chambers made 112 decisions in 2007 and 146 decisions in 2008 concerning unbalanced budgets (National Court of Accounts 2009c).

If the budget deficit exceeds 5 or 10 percent of receipts, depending on SNG size,[30] the Prefect may call on the RCA to intervene. The Prefect is required to refer inaccurate or illegal budget decisions to the RCA within one month. The cases to be referred include, but are not limited to, those in which the operating budget is in deficit, or in which compulsory expenditures such as debt service are not included in the budget.

The RCA issues proposals within two months to ask SNGs to balance their budgets, which may include the SNGs cutting expenditures and raising taxes. The Prefect must send the revised budget for the next fiscal year to the Chamber. If the municipality has not taken sufficient deficit-cutting measures, the RCA proposes other measures to the Prefect within one month. The Prefect may seize fiscal control and impose a budget. Alternatively, the Prefect may reject the proposals made by the

Chamber, but must explain why. There were 119 such RCA interventions in 2006 for these controls.[31]

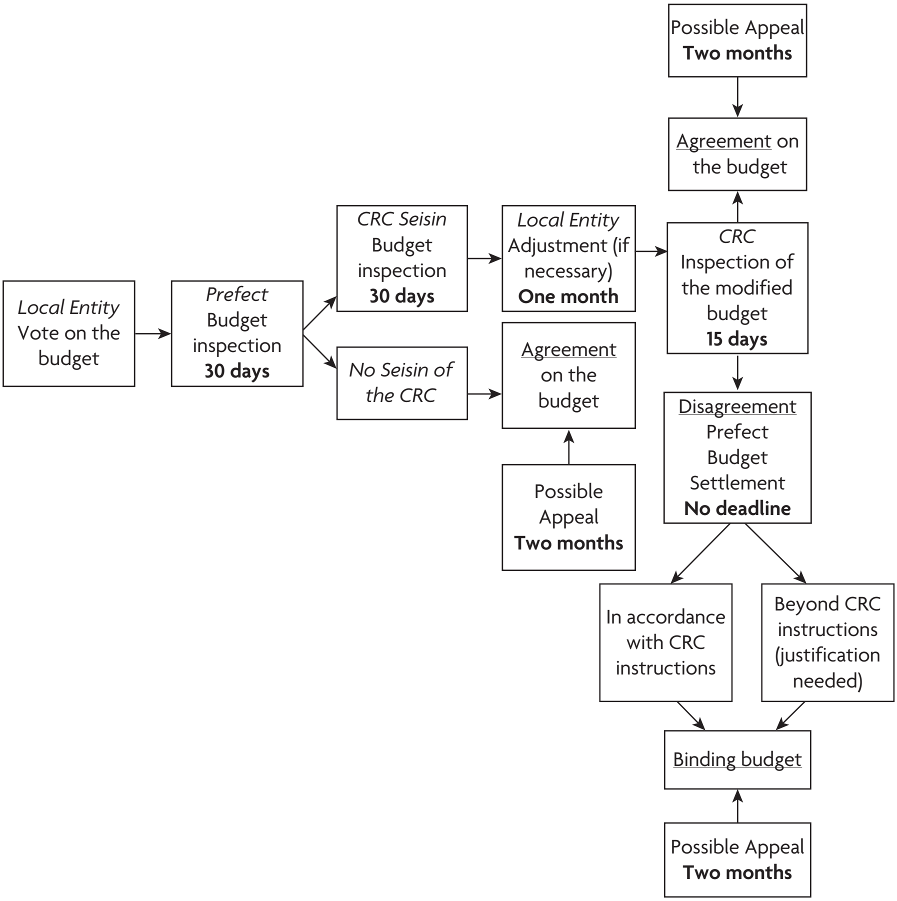
Compulsory expenditures must be included in the budget and must be paid. The Prefect, or any other person adversely affected by their exclusion, can initiate proceedings before the competent Chamber. This is the most common reason the RCAs are called on (Bouvier 2008). For instance, debt service, including both principal and interest, constitutes a compulsory expenditure. Debt service must, therefore, be entered as an expenditure item in the annual budget. If debt that is due is unpaid, a lender can ask an administrative tribunal to include the debt service in the SNG's budget and enforce payment (*mandatement d'office*) (Articles L. 1612-15 to L. 1612-17 of the CGCT). The Prefect has the right to refuse the RCA recommendations, but must explain the reasons for the decision. If the Prefect accepts the decision of the Chamber, and unless the SNG can defend against such action on the grounds that the sum is not in fact due, the tribunal decides in favor of the lender. The payment order is issued, and the Public Accountant pays the debt.

Funds, of course, need to be available in the SNG account to execute a payment order. This is essential for budget control. The measures may not be successful if the financial distress is discovered late. Herein lies the essential role of RCAs. In the case of Pont-Saint-Esprit, the National Court of Accounts recommended several measures to ensure the enforcement of recovery proceedings, such as the compulsory publication of prefectoral decisions before town council deliberations, and the recognition of personal liability if the measures are not executed (National Court of Accounts 2009a).[32]

Tax receipts regularly flow into SNG accounts. If the available funds are insufficient for payment, the representative of the central government in the department issues an overdue notice and calls on the entity in question to create the necessary resources for payment. If the assembly of the SNG or the public entity does not create the necessary resources, the representative of the central government in the department or the supervisor takes over and, when necessary, orders payment (*mandatement d'office*) (figure 6.5).

Oversight of SNG budgets by the central governments requires internal controls of SNGs. Indeed, facing an increase of SNG expenditures over the last 25 years, SNGs have strengthened internal management

Figure 6.5 Budgetary Control and Appeal Proceedings, France



Source: Robert 2009.
Note: CRC = *Chambre Régionale des Comptes* (Regional Chamber of Accounts).

control systems not only to ensure the legal validity of their budgetary accounts but also to achieve their goals at lower costs. More recently, a growing number of municipalities have collaborated with respect to their financial control systems through intermunicipal cooperation arrangements, for example, as regards the (costly) training of staff specialists. The Rapport Balladur (2009), the Rapport Mauroy (2000), and the Rapport Richard (2006) encouraged such cooperation.

Management control by the central government refers to the decisions made ex post by the courts, most often in the form of reports.

The role played by courts has increased over time, though some SNG politicians have been critical of their growing role. Indeed, even if the courts only pass on whether the funds have been used for their intended purposes, local councillors often consider this a means of questioning their management and policy priorities, which is why these proceedings are suspended during elections. The law of December 21, 2001, forbids value judgments (see Article L. 211-8 of the *Code des juridictions financières* [Code of Financial Tribunals]).

The Chamber has special powers to enable it to perform its duties (for example, it has access to all necessary documents). At the end of the audit, the Chamber sends an interim report to the controlled local government, which can reply or request a hearing. The Chamber analyzes the audit and publishes a final report. The local government can respond a second time. Its replies will be published with the report and will be accessible to the public.

The Public Accountants

France distinguishes between the expenditure function and the treasury function. *Ordonnateurs* (ministers, mayors, and presidents of local councils), who order expenditures, are separate from *comptables* (Public Accountants), who make payments and manage the funds.[33] All Public Accountants are central government civil servants. They are appointed by the Finance Minister to perform treasury and accounting functions.[34] They record SNG receipts and order payment of SNG expenditures on behalf of SNGs. Public Accountants ensure compliance with budgetary rules; they do not decide budgetary priorities. The decision by a Public Accountant not to pay an expenditure item may be overridden by the *ordonnateur* pursuant to an *ordre de requisition*, to make the payment out of the SNG funds. However, the *ordonnateur* is liable with his personal assets if the expenditure violates the budgetary rules.

As regards receipts, the control by Public Accountant is more limited. Tax revenues are controlled by the fiscal administration, and Public Accountants simply record and verify receipts.

With respect to expenses, Public Accountants are personally responsible for failing to perform their duties. They are potentially liable for all financial transactions. They verify the budgetary allocation, expenditure items, debt and its servicing, revenue receipts, the availability of funds, and the clauses of the financial transactions. In the event of noncompliance with these requirements, Public Accountants are obliged to suspend the financial transaction.

Public Accountants, who exercise ongoing controls over SNG finances, are themselves subject to two types of control: administrative and jurisdictional. With respect to administrative control, Public Accountants are supervised by the *Tresorier-Payeur General* (State Treasurer), the highest-ranking public accountant.[35] Internal audit within the Ministry of Finance is performed by an internal audit unit—the *Mission d'audit, d'évaluation et de contrôle* (Audit, Evaluation and Control Group)—and the *Inspection Generale Des Finances* (General Inspection of Finance)—a group of top civil servants acting as a senior auditor and advisory service for the Ministry of Finance. This is to ensure that Public Accountants comply with laws and regulations and carry out antifraud enforcement. Members of the General Inspection of Finance have special powers (access to all necessary documents, particularly to the records of all Public Accountants, and the right to suspend accountants temporarily in cases of fraud).

With respect to jurisdictional control, though not in charge of administrative control of Public Accountants, the RCA can issue judgments against a Public Accountant, as a follow-up of the compliance audits they perform on local authorities. If a Public Accountant fails to perform his or her duties, he or she is legally liable and must pay with his or her own personal funds, if necessary. If the accounts are judged as regular, Public Accountants are exonerated from liability.

France has a unique system for managing SNG cash. All state and SNG funds are centralized daily in a single state treasury account. Public accountants accept all receipts and authorize all expenditures that are in compliance with budgetary rules. The general rule is that SNGs must deposit all cash with the State Treasurer. For payments, the SNG requests the Treasurer to pay the debtor, the so-called payment order (*mandatement*). Revenues, transfers from the central government, and subnational tax receipts—subnational taxes are set by the SNG but are collected by the state's tax collection agents—are also transferred to the SNG's noninterest-bearing cash account held by the Treasurer. In return, the Treasury does not charge SNGs for managing their cash and can advance money against future tax revenues when SNGs do not have sufficient cash.

New procedures have been developed since 2006 to facilitate the control exercised by Public Accountants. These controls operate at several levels. New instruments, such as the computer system Helios, ensure that the control of recurrent expenditures is systematized and separated from the control of unusual expenditures. In the same way, the system of *Contrôle hiérarchisé de la dépense* (Multi-layered Control of Expenditures) establishes a set of controls. This system helps Public Accountants redefine their priorities.

Subnational Debt

Subnational Borrowing Framework

Before the decentralization laws of 1982, the Prefect exercised ex-ante control (*contrôle a priori*), preventing a municipality, department, or region from borrowing if the loan was determined to be unfavorable to the interest of the SNG (that is, if the loan would result in overborrowing). Moreover, only two state-owned financial institutions could lend money to subnationals.[36]

In 1982, SNGs became responsible for their own borrowing and could decide whether and how much to borrow without ex-ante control. In 1986, the central government stopped offering loans with privileged interest rates to SNGs. The same year, the requirement to borrow from government lenders was abolished. Currently, SNGs mainly rely on bank loans, and compared to the subnational bond market in the United States, the French subnational bond market is tiny: more than 20,000 U.S. SNGs and federal and local government-owned enterprises are rated compared to about 40 in France.[37]

In the early 1990s, some municipalities in France experienced severe financial distress. In the second half of the 1990s, the central government tightened the regulatory framework for SNG borrowing, introduced greater disclosure and transparency requirements, and implemented an early warning system.

Key elements of prudential rules regulating debt, liquidity, and contingent liabilities include the following:

- New long-term borrowing must fund capital investments only.
- Debt payments are compulsory expenditures and must be fully budgeted.

- Annual debt service, including that paid on guaranteed loans, must be less than 50 percent of operating revenue.[38]
- No single borrower may benefit from a guarantee exceeding 5 percent of the SNG's operating revenue.[39]
- Guarantees may not exceed 50 percent of the principal.

SNGs are required to deposit cash with the central government, which carries out all payments following the control framework discussed in the previous section. In addition to the borrowing framework, SNGs must also follow certain accounting and budget rules. These rules include balanced budget rules requiring that both operating and capital accounts be balanced and annual debt service be covered by SNG own revenues.

Subnational borrowing can take the form of a loan, a bond issue, or other instruments including structured products. There must be a positive balance in the operating budget so that it can cover principal payments.[40] Article L. 2122-22 of the CGCT states:

> The mayor may, in addition, on delegated powers of the city council, be authorized, in whole or in part, and for the duration of his mandate:
>
> To borrow, within the limit set by the city council, for the purpose of financing investments as foreseen in the budget, and for financial operations that are useful for managing its lending, including hedging for interest and exchange rate risk.

According to articles L. 200-3, L. 335, and L. 4333-1 of the CGCT, municipalities, regions, and departments may borrow. According to Article L. 2331-8 of the CGCT, the proceeds from borrowing constitute nonfiscal income in the investment section of the SNG budget. Borrowing is defined as the aggregate of all debts contracted with a maturity exceeding one year during the legislative period and allowed for capital investment only. Short-term borrowing with a maturity shorter than one year is treated differently.[41] This short-term debt finances the liquidity of SNGs and is allowed for all types of expenditures.

Subnational borrowing is not subject to the compulsory submission of bids from several lenders,[42] although SNGs are required to hold a tender for other banking and investment services if they exceed a certain threshold.[43]

Nevertheless, even if SNGs became responsible for their own borrowing, their freedom of management is still limited by the control of RCAs, which can declare certain SNG acts void. This control does not contravene the progressive autonomy granted to SNGs, but is in accordance with the law. Thus, subnational borrowing must conform to several rules, such as the prohibition against financing day-to-day management by resorting to borrowing, the prohibition on speculation, and the requirement of publishing borrowing activities as part of budget documents. In this respect, contracts must fulfill the conditions defined by the *Conseil national de la comptabilité* (National Council of the Comptroller) in its ruling of July 10, 1987, to be considered as financial risk management instruments. The publication of information on borrowing activities attached to budgetary documents is necessary to inform local councillors and citizens about the financial commitments of the subnational entity (with a list of the establishments the entity has contracted with) (Robert 2009).

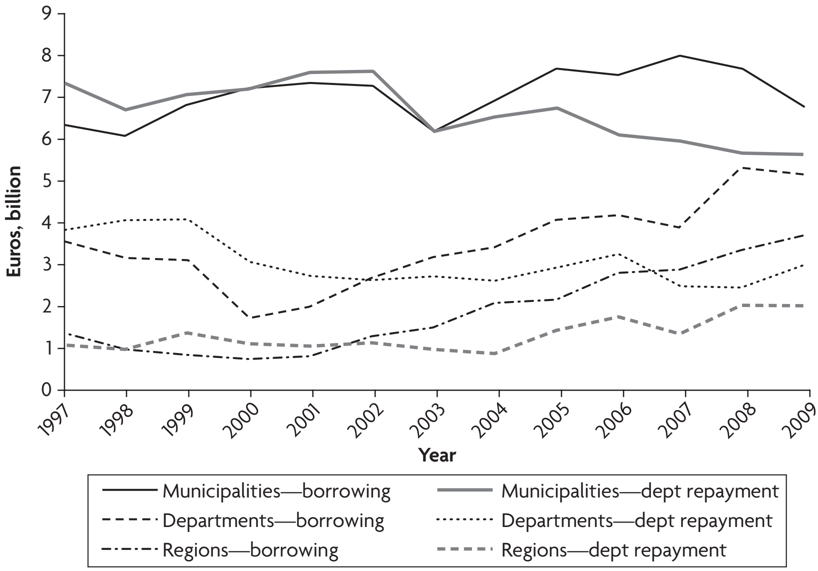
Evolution of Subnational Debt in France

Following passage of the 1982 decentralization laws, the subnational debt-to-expenditure ratio increased. SNG debt accounted for 11.1 percent of GDP in 2007, up from 8.5 percent in 1982 (Rapport Pébereau 2005). This increased borrowing financed new social, economic, and infrastructure programs resulting from the devolution of new responsibilities to SNGs.

In 2009, municipal borrowing reached €6.75 billion compared to €5.1 billion for departments and €3.6 billion for regions. Until 2002, the three levels of SNGs managed to have positive net repayments (meaning that their debt repayment was higher than their borrowing). Since then, the trend has reversed. There has been a significant increase in the borrowing of regions, departments, and municipalities—up 153, 64, and 10 percent, respectively, between 2003 and 2009 (figure 6.6).

This trend is partially due to the Law on Local Rights and Responsibilities (Law 2004-809), which deepened the devolution process. New responsibilities were transferred to SNGs during 2005–07, particularly to regions and departments. For instance, regions are responsible for social and health care and education services, economic development, vocational training, and grants to private high schools. Departments are responsible for assistance for the young, social funds for housing, grants provided to disabled people, management of some nonteaching staff in

Figure 6.6 SNG Borrowing and Debt Repayment in France



Source: DGCL 2011.

junior high schools, management of some formerly national roads, and grants to private junior high schools (Fitch Ratings 2008a).

The Lenders

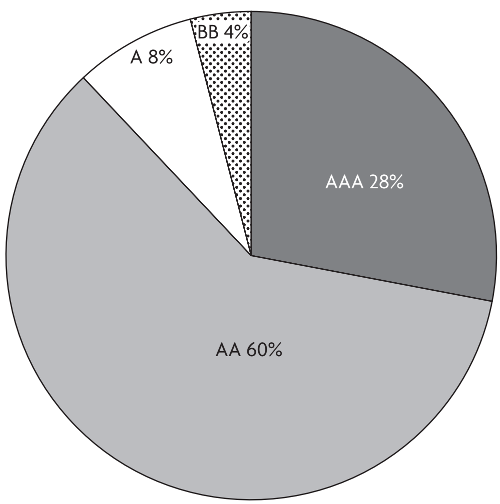
Until 1987, the *Crédit Local de France*[44] had a monopoly on municipal lending. Since then, the French subnational credit market has been, in essence, an oligopoly composed of four banks—Dexia (by far the largest bank in this market), Caisse d'Epargne, Crédit Agricole, and Société Générale—which together control 80 percent of the market. Dexia, in particular, played a leading role in the aggressive selling of structured products, and received heavy blame following the global financial crisis. With the crisis, Dexia entered a period of turbulence and survived due to central government support. The bank shed a number of its subsidiaries abroad. The support by the government created particular controversy in light of widespread allegations that Dexia aggressively overloaned to SNGs, both in volume and in terms of risky products.

From 2000 onward, few foreign banks have made loans to SNGs. The Swiss bank UBS tried unsuccessfully to enter the market in the early 2000s. In contrast, the Royal Bank of Scotland managed to lend to some SNGs, such as the city of Aubagne.[45] Most SNGs get financing through bank loans. There are exceptions, such as the City of Paris: in 2008, €331 million was raised, €251 million of which was in the form of bonds and only €80 million of which was in the form of bank loans (Mairie de Paris 2009). Since the early 2000s, SNGs have had the opportunity to borrow through the following channels: bank loans (fixed-interest loans, variable-interest loans, structured loans, and revolving loans denominated in euros or in foreign currency), or bond issues (short-term commercial paper, medium- or long-term securities, and derivative bonds).

Creditworthiness of SNGs

SNGs willing to issue bonds need a rating. As of December 26, 2011, Moody's, Fitch, and Standard & Poor's (S&P) rated 3, 9, and 13 SNGs, respectively. Unlike sovereign and corporate borrowers, most SNGs are rated by a single agency. All rated SNGs are in the investment grade category with the exception of the Overseas Territory of French Polynesia, which was rated BB+ by S&P.[46, 47] Eighty-eight percent of SNGs are rated AAA/Aaa or AA/Aa, which reveals strong creditworthiness overall (figure 6.7).

Figure 6.7 Distribution of Ratings Assigned to French SNGs



Source: Authors' computations from Fitch, Moody's, and S&P.

Note: SNG = subnational government. Ratings are Fitch, Moody's, and Standard & Poor's as of December 26, 2011. There are 25 SNG ratings.

Managing Subnational Contingent Fiscal Risks

There are two types of SNG contingent fiscal risks.

The first fiscal risk comes from potential liabilities of companies owned by SNGs.[48] In addition, SNGs sometimes guarantee liabilities of other entities. Rating agencies typically count the debt incurred by such companies as the indirect debt of the local government that owns the SEM. In Fitch's ratings of the nine French SNGs in December 2011, the net indirect debt plus guarantees range from 0.1 to 74.7 percent of net overall debt, with an average of 31.1 percent (table 6.3). Regulations on SNG companies have been tightened, including the compulsory publication of guarantees, ownership, and subsidies. No single borrower may benefit from a guarantee exceeding 5 percent of operating revenue, and guarantees may not exceed 50 percent of the principal. Table 3 provides a snapshot of the scope of indirect debt of selected French SNGs.

Table 6.3 Debt Data for French SNGs Rated by Fitch

Fitch data	Net direct debt (million euros)	Net guaranteed + indirect debt (million euros)	Net overall debt (million euros)	Net guaranteed + indirect debt)/net overall debt (%)	Year	Rating (as of December 26, 2011)
Essonne (department)	780.3	220.9	1,001.2	22.1	2009	AA
Guadeloupe (department)	110.6	215.8	326.4	66.1	2010	AA–
Île-de-France (region)	3,506.8	11.3	3,518.1	0.3	2010	AAA
Paris (city)	2,695.0	7,957.0	1,0652.0	74.7	2010	AAA
Picardie (region)	471.5	0.4	471.9	0.1	2009	AA–
Provence-Alpes-Côte d'Azur (region)	1,664.1	150.0	1,814.1	8.3	2010	AA
Rhône-Alpes (region)	1,357.2	48.2	1,405.4	3.4	2009	AAA
Seine-et-Marne (department)	892.2	585.3	1,477.5	39.6	2010	AA
Strasbourg (city)	151.9	285.1	437.0	65.2	2010	AA+

Source: Compilation of various reports from http://www.fitchratings.com.
Note: SNG = subnational government.

The second fiscal risk results from the strong growth of complex structured products since the 1990s. Structured products with increasingly risky instruments combine various derivative instruments with a loan structure. At end-2007, the volume of structured products was €30 billion to €35 billion in total borrowings of €137.5 billion (Fitch Ratings 2008a).

The first step toward structured products took place in the 1990s, when SNGs tried to renegotiate their debts with fixed interest rates (Paris 2009). Since interest rates were higher in the 1980s and declined sharply in the 1990s, such renegotiation enabled the SNGs to reduce their debt. Banks even offered such products to small SNGs. The National Court of Accounts had already published a report, in 1991, about debt management, focusing on the increasing importance of structured products in SNG debt.

Four types of structured products were used: (a) borrowing with variable interest rates (with options to minimize risk), (b) products with barriers (the interest rate is guaranteed until an index reaches a threshold), (c) snowballing products (discussed below), and (d) products indexed on an exchange rate or a difference in inflation levels.

For products with barriers, the interest rate is fixed until a threshold is crossed. For most of the 2000s, the threshold was not reached. When the global financial crisis hit, interests rates often came close to the threshold. Once the threshold is crossed, the interest rate increases quickly.

Snowballing products are those for which the interest rate depends on the difference between a long-term and a short-term interest rate. Traditionally, the long-term rates are higher than short-term rates, which explains the attractiveness of this product and reflects the risk linked to the length of the maturities. However, when financial conditions deteriorate, the yield curve often reverses, with short-term interest rates being higher. In this kind of product, the interest rate is fixed as long as the requisite difference between the long-term and the short-term interest rate persists. If the difference narrows by too much, the fixed rate turns into a variable rate. Since maturities are typically long, foreseeing the full budgetary impact of such products is difficult, especially for SNGs without sufficient in-house financial expertise.

The same principle applies to other products: the initial fixed interest rate (which is linked to an index) is attractive to the borrower, but beyond a given threshold of this index, this interest rate increases. Considering that the maturities are long (several decades for the majority of these structured products), the central problem is that interest rates cannot be reliably projected in the long run.

The transition from a fixed interest rate to a variable interest rate can gravely impact SNG financial accounts. In this case, two solutions are possible: to settle borrowers' accounts or to renegotiate the loans.

In addition, several surveys conducted by RCAs established that SNGs having financial difficulties are frequently those that have exposure to these structured products.[49] The recent evolution of the SNGs' financial position confirms this. Since 2003, SNG borrowings have had longer maturities, with an increased use of structured products. The increased availability of structured products with combined fixed and variable rate terms has proved to be particularly risky.

Public accounting standards have lagged behind in reflecting the new challenges that these structured products pose for transparency and debt profile. Risks and costs of these products are often not adequately evaluated and understood. In December 2011, a report released by an ad-hoc parliamentary commission estimated that €13.6 billion of SNG structured debt was "toxic," thereby likely to weaken the financial position of French local governments.[50] Efforts are ongoing to better regulate and restrict the use of structured products.[51]

Resolving Subnational Financial Distress

French law distinguishes between private and public law. Private law is the law of coordination and voluntary cooperation, and in private law, the actors are in a horizontal legal relationship. Public law is characterized by vertical legal relationships, with the central government exercising sovereign authority and commanding the legal subjects to act as prescribed. Public law is fundamentally asymmetric. The mechanisms for coping with subnational financial distress are found in administrative law (public law), which emphasizes prevention and oversight by the central government. However, the financial distress of SEMs (with public ownership between 50 and 85 percent) is subject to private law (including corporate insolvency law).

Before decentralization, subnational defaults in France were extremely rare.[52] Because the decentralized system of subnational finance is less than three decades old, case studies are few. In the early 1990s, one estimate put the number of municipalities experiencing overindebtedness at about 2,000 (out of more than 36,000 municipalities), of which 40 were experiencing severe financial difficulties (Moody's Investors Service 2002). Other tiers of SNGs (departments and regions) have also experienced subnational financial distress, although there have been few cases.[53] Actually, both domestic and foreign lenders rushed to lend to municipalities, in the mistaken belief that there was little risk because public entities were involved.

After several cases of subnational financial distress in the early 1990s, both the subnational borrowing framework and accounting systems were strengthened, as discussed above. (The risks of structured products materialized only in the 2000s [these products were not previously available]). An early warning system (*réseau d'alerte*) was launched, and the training of local civil servants was intensified. The overall goal was to achieve greater transparency and disclosure, and thereby reduce municipal financial risk. Recourse to speculative financial instruments was tightly regulated, but these standards were loosened after 2000.

Starting in 2008, the global financial crisis put the finances of French cities and regions under strain. Most of them did not use structured products, even if such borrowing looked attractive. Nevertheless, a growing number of SNGs experienced difficulties when credit markets dried up in the second half of 2008 (Cossardeaux 2008). The subnational borrowing market shrank in volume. The crisis also led to a decrease in tax revenues and tax allocations from the central government. About 1,595 SNGs used structured products that turned out to be toxic.[54] Other estimates are that up to 25 percent of SNG debt used structured products. The French central government committed to help local authorities face their credit needs and pressured banks to accept subsovereign debt restructurings.

Facing a slowdown of their tax revenues and losses related to the slowdown in the real estate market (for example, the *droits de mutation* [property transaction tax]), SNGs were experiencing a severe credit crunch in late 2008. The risks of structured products added to these financial difficulties. The crisis in SNG finances may continue for years. Some SNGs may have to choose between cutting investments or borrowing more to fulfil their enlarged responsibilities, thereby jeopardizing their creditworthiness. Ex-ante rules, such as the balanced budget rule or the debt-service-to-revenue ratio, combined with the early warning system, may have reduced the risk of systemic SNG financial distress in the future.

To help SNGs cope with the impact of the global financial crisis, the central government reduced the delay in refunding the value-added tax to SNGs, enabling them to maintain capital expenditures in 2009 above the 2004–07 average. The expected value-added tax refund payments in 2009 totaled more than €4 billion, equivalent to 8 percent of SNG capital expenditures that year. Overall net borrowing by French SNGs increased by €5.1 billion in 2009, while total outstanding debt as a share of GDP increased by 4 percent over 2008. The growing financial difficulties of French SNGs (particularly departments and municipalities) have prompted the central government to establish a new bank that would fund local governments and make an exceptional transfer (of €3 billion to €5 billion) to SNGs in 2012.[55]

The ex-ante regulations and the oversight by the central government, as discussed in previous sections, have substantially reduced the risks of defaults and, thus, uncertainties facing lenders. Nonetheless, fiscal and default risks exist despite ex-ante rules. If an SNG becomes insolvent, the negotiated nature of debt workout and fiscal adjustment cause uncertainty to lenders due to a lack of a priority structure that would have existed with a formal insolvency system. As mentioned, there is no insolvency law that applies to SNGs. Although the procedures for dealing with SNGs that are breaching fiscal rules are clear, the procedure for dealing with SNG defaults is not detailed in legislation, such as the CGCT, but is shaped by administrative practice.

These mechanisms are largely informal, unbounded by legal constraints and with less reliance on precedents than civil law. Even though the payment order mechanism theoretically offers extremely strong security to lenders, it requires sufficient income for the payment of all compulsory expenses. Moreover, lenders have few remedies under civil law, such as seizing SNG assets. Liens on assets that are essential for the performance of public services are illegal based on the premise that interrupting public services would be counter to the public interest. Similar restrictions exist in other countries, including the United States.

Even though the Prefect and the RCAs have the authority to enforce a recovery plan and to release additional revenue in the case of financial difficulties, these powers have proved insufficient to prevent some municipalities from defaulting. The view that the central government always guarantees subnational debt is incorrect. Nevertheless, under the provisions of articles L. 2335-2 and L. 1524-4 of the CGCT, there is a procedure for exceptional state aid for SNGs in financial distress. Article L. 2335-2 states:

> Under the provisions of article 1524-4, exceptional subventions can be granted by Ministerial order … to municipalities in which unusual circumstances have led to specific financial difficulties.

In reality, the amount of extraordinary aid has been small. In 2006, only 12 municipalities benefited from these subsidies, for a total of €1,593,682 (Robert 2009). The allocation of these subsidies is subject to three conditions: (a) a municipality can receive exceptional subsidies only if the budget is unbalanced (as defined in article L. 1612-4 of the CGCT), (b) this imbalance led to a case before the RCAs (indeed, the subsidies can be granted only after the audit of the budget by the RCAs), and (c) the recovery measures taken by the Chamber must have been inefficient (they cannot absorb the deficit of the operating budget).

The Ministry of Home Affairs and the Ministry of Finance have compiled a list of subnational entities in financial distress. However, there is no power of coercion against an entity that refuses to cooperate with a restructuring plan. A subnational entity cannot be placed under supervision a priori. The current framework reaches its limits in cases of extreme financial distress; that is, there is no established procedure for restructuring debt with lenders that are unwilling to cooperate. In crisis, there is a three-party negotiation system: the central government, SNGs, and lenders (only a limited number of banks lend to SNGs). It is a predictable negotiation system, even though the outcome of the negotiation depends on the balance of power among three parties. Notwithstanding the above, there is no rules-based framework for dealing with subnational financial distress, and the nature of the policy response may thus differ from case to case.

The implementation of an early warning system began in 1993 and only applied to municipalities of more than 10,000 inhabitants. The *Direction Générale des Collectivités Locales* (General Directorate of Subnational Entities, DGCL) and the *Direction Générale de la Comptabilité Publique* (General Directorate of Public Accounting, DGCP) had each developed a system to analyze the accounts of municipalities to detect financial distress. The two systems were based on the analyses of certain ratios, which are presented in table 6.4.

Under the DGCP system, the financial situation of a municipality is considered to be critical if it exceeds three thresholds, and extreme if it exceeds four thresholds, as explained below.

The DGCP and the DGCL later realized the efficiency of their system was limited, for two reasons: the system was centralized nationwide, and the number of ratios was excessive. In this respect, the revision of the warning system in 2001 was based on implementation of this system in all municipalities, the decentralization of the system at the departmental level, and the simplification of the ratios system, with four ratios inspired by the initial DGCP system. Each ratio has a critical threshold and rates the municipality on a scale of zero to 100. The situation is considered critical when the ratio falls below 30, and extreme when it falls below 20. The list of municipalities in financial distress is sent to the Prefect, who has the option of intervening, of providing such information to the RCA, or both. The results are for the mayor's private

Table 6.4 Main Ratios Used by the French Central Government to Detect Financial Distress

	DGCL	DGCP
Ratios	Indebtedness and financing = 4 ratios Budget structure and rigidity = 2 ratios Fiscal pressure = 1 ratio	Cash flow = 1 ratio Rigidity of structural expenses = 1 ratio Fiscal leeway = 1 ratio Excessive debt = 1 ratio
Method	Qualitative evaluation	Implementation of quantitative thresholds

Source: Robert 2009.

Note: DGCL = *Direction Générale des Collectivités Locales* (General Directorate of Subnational Entities), DGCP = *Direction Générale de la Comptabilité Publique* (General Directorate of Public Accounting).

information (publication is at his or her discretion), and the list of the concerned critical municipalities is centralized through the DGCP and the DGCL. In the most extreme cases, the departmental treasury can conduct an additional audit.

Generally, caution must be used when assessing the creditworthiness of SNGs. Ratios taking into account the local population are not necessarily accurate, because most local revenues come from firms and not from householders. The most reliable indicators are discretionary own-source revenues to operating revenues, the total debt to operating revenues, and the debt-service-to-operating-revenues ratios. Also worth considering is the taxing capacity and assessing to what extent the SNG is able to increase taxes.[56]

There is a question as to whether SNGs use structured products to engage in speculation[57] or to actively manage debt. In practice, distinguishing between speculation and optimization of debt is difficult. Risky borrowing just after elections provides a measure of budgetary freedom to the new executive. At the same time, it creates an electoral cycle in SNG investments, and thus substantial fiscal risk. According to one view, banks and SNGs share the blame. Banks object, saying that SNGs took advantage of the lower interest rates provided by structured products in the past and must live up to their responsibilities when circumstances change. They also claim that the current situation is exceptional due to the global financial crisis.

The recent growth in structured products used by a growing number of French SNGs poses additional challenges to the resolution of financial distress. The growth of structured products combined with the financial crisis has increased the risks of financial distress. The government has begun to address the challenges of structured products. In its report, “Les risques pris par les collectivités locales et les établissements publics locaux en matière d’emprunt,” (National Court of Accounts 2009b), the National Court of Accounts stresses three points on how to improve SNG debt management.

First, the role of elected assemblies needs to increase. Currently, the CGCT grants the regions, departments, and municipalities considerable freedom regarding the operations they consider necessary, and there are no specific measures regarding structured products. According to the Court, it would be advisable to structure and redefine precisely the delegation of power to these assemblies.

Second, improved accounting and transparency is needed. Indeed, the accounting norms enforceable to SNGs do not at present include any specific accounting framework for structured products. Moreover, the lack of accounting of the risks linked to the possession of structured products seems to be in contradiction to the general principle of caution, as defined in the General Accounting Plan (Article 120-3).[58]

Third, since decentralization abolished direct control by the central government over SNG actions, and especially over their borrowing, there is a need to improve the openness of SNG policies. Indeed, since SNG goals reflect the intentions of the party in power, communication between citizens and deliberative assemblies must be improved. In this regard, the SNGs could make available to citizens reports that could inform their choices.

In 2008, a tripartite meeting gathered representatives of banks, SNGs, and the Minister of Home Affairs. They decided to treat the difficult cases individually. The minister insisted on better information by comparing the financial situation of all SNGs. Another emphasis was on transparency: banks are subject to stress tests and must keep politicians abreast of the financial situation.[59] After the meeting among the representatives of the central government, the SNGs, and the banks, agreement was reached in November 2008 on two propositions: (a) dealing with subnational financial distress is the responsibility of the concerned SNG and its banks, and (b) a code of good conduct is to be developed to provide a framework for the relationship between the banks and the SNGs.

In May 2009, the Ministry of Finance proposed a code of good conduct. Under it, banks may not sell structured products to SNGs that risk a loss of capital, or risky products indexed to volatile variables such as exchange rates. Banks must indicate the position of their products on a predetermined risk scale. These measures preserve much of the autonomy of SNGs.[60] The fact that they are not binding illustrates the ad-hoc nature of the policy response to relatively widespread subnational financial distress, and the reluctance of the central government to develop a more structured framework.

Both banks and SNGs agreed on several points: (a) SNGs should actively manage their debts without a priori control by the central government; (b) competition among banks should be maintained; and (c) a balance should be reached between financial innovations and constraints specific to public administration. The agreement took effect on September 1, 2009, and the elements, called commitments, contained therein are as follows:

Commitment 1: Banks promise not to sell products whose principal payment is risky or linked to risky indexes. Risky indexes include an exchange rate in a currency not held by the SNG, prices of raw materials, and equity investments. It is also forbidden to sell products linked to indexes not related to the SNG investments or those from a non-Organisation for Economic Co-operation and Development country.

Commitment 2: Banks commit not to sell products with cumulative products that are particularly sensitive to interest rate shocks.

Commitment 3: Banks accept the requirement to provide a transparent index of riskiness when proposing products. Each product is rated on two common scales of five levels each. One scale refers to the riskiness of the index the product is linked to, and the other refers to the structure of the product. This should increase the transparency in comparing structured products.

Commitment 4: Banks acknowledge that SNG executives do not have financial expertise and that the executives should be well informed at all times. All the documents should be in French. The drawbacks and the risks of each product should be clearly shown. Past behavior of the indexes should be analyzed. Stress tests should be conducted showing how the product behaves in case of sharp corrections of the index.

Commitment 5: SNGs commit to improving the transparency of the decisions taken regarding borrowings and debt. SNG executives should present the current financial situation to the entire municipal council. The council may authorize the executive to buy products of a certain risk level on the two scales.

Commitment 6: SNGs commit to make public the structured products they subscribe to, the indexes they are linked to, and the structure of the products. This increased transparency should improve the decisions taken in the budgetary meetings. The executives should receive authorization from the municipal council before committing to a new product.

Former French president Nicolas Sarkozy created a *Comité pour la réforme des collectivités territoriales* (Committee for the Reform of Territorial Entities) at the end of 2008 to "determine measures to simplify SNG structures, to clarify the distribution of their competences and to allow a better allocation of their financial means, and to formulate useful recommendations."[61] Twenty propositions were presented by the committee to the president on March 5, 2009, (Rapport Balladur 2009). Regarding the simplification of SNG structures, the committee suggests reducing the number of metropolitan regions from 22 to 15. Abolition of the departments is not planned, but the report insists on the necessity of redefining the competencies of existing departments. At the municipal level, the prerogatives of the mayors are not modified, but the committee intends to strengthen the intermunicipal cooperation structures. Between 2009 and 2014, a new land allocation and new voting system could be implemented.

Conclusions

During 1982–83 and 2003–04, two waves of decentralization in France devolved more powers to the three levels of SNGs: the municipalities, the departments, and the regions. This new institutional framework has enabled SNGs to enjoy a greater degree of autonomous expenditures, to raise their own taxes, and to borrow from financial markets, within ex-ante rules established by the central government. However, SNGs are subject to ex-post controls by the Prefect and the Regional Chambers of Accounts, and to ongoing controls by the Public Accountants.

The ex-ante fiscal rules and the regulatory framework for managing SNG fiscal risks were established after a period of unregulated borrowing by SNGs following the decentralization and subsequent debt stress experienced by some SNGs. The regulatory framework combines the laws and regulations with three sets of institutions, while preserving considerable SNG fiscal autonomy. The laws and prudential rules regulate debt, liquidity, and contingent liabilities. The state exercises strong supervision and monitoring of SNG financial accounts through the Prefect, the Regional Chamber of Accounts, and Public Accountants.

The French system, which combines decentralized responsibilities and fiscal decisions with fiscal monitoring by the central government, offers valuable experience for countries undergoing decentralization. State supervision has resulted in the avoidance of major SNG defaults—although several debt restructurings occurred in recent decades, which partly explains the high credit ratings—"AA," on average—assigned by rating agencies. Nonetheless, the lack of a clear, established legal structure for priority payments creates uncertainties. Off-budget entities, such as SEMs, pose contingent fiscal risks, a common challenge across countries.

Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

1. Standard & Poor's downgrading of France's sovereign credit rating in January 2012 (Standard and Poor's 2012) will have implications for subnational finance in France; the assessment of such implications is beyond the scope of this chapter.
2. In this chapter, the term *local authorities* and the term *subnational* governments are used interchangeably.
3. *Titre XII: Des Collectivités Territoriales* (Title XII: Territorial Entities).
4. Article 72 of the French Constitution, October 4, 1958.
5. Article 74 of the French Constitution. The four regions are French Polynesia, Guyana, New Caledonia, and Wallis and Futuna. The four departments are Corsica, Guadeloupe, Martinique, and Reunion Islands.
6. The Law of March 2, 1982, known as the "Defferre Law," because Gaston Defferre was then Minister of Home Affairs.

7. Laws are referred to by date in this chapter.
8. Article 1 of the Constitution.
9. Article 72 of the Constitution.
10. Article 72-2 of the Constitution. The terms are defined under the constitutional law of July 29, 2004.
11. Article 72 of the Constitution.
12. Articles 72 and 72-1 of the Constitution.
13. Article 72-2 of the Constitution.
14. Article 72-3 of the Constitution.
15. DGCL (Direction Générale des Collectivités Locales) 2011.
16. Law on Inter-Municipal Bodies of July 12, 1999 (also called the Chevènement Law).
17. Dexia 2008.
18. Law of July 7, 1983.
19. Because their assets are immune from attachment, public establishments are not subject to the liquidation law of January 25, 1985.
20. DGCL 2011.
21. DGCL 2011.
22. The business tax was abolished in 2010 and was replaced by the Territorial Economic Contribution (*Contribution Economique Territoriale*).
23. The central government reduced the delay in refunding the value-added tax to SNGs, enabling them to maintain capital expenditures in 2009 above the 2004–07 average. The expected value-added tax refund payments in 2009 was more than €4 billion, equivalent to 8 percent of SNG capital expenditures in 2009. Overall net borrowing by French SNGs increased by €5.1 billion in 2009, while total outstanding debt as a share of GDP increased by 4 percent over 2008. However, debt accounts for only 4.2 years of overall SNG current balance.
24. These 11 departments are Ardennes, Cher, Corrèze, Creuse, Haute-Loire, Haute-Saône, Indre, and Meuse (which are rural and poor departments), and Pas-de-Calais, Seine Saint-Denis, and Val d'Oise (which are urban and poor departments).
25. For instance, the number of beneficiaries of the Active Solidarity Income (Revenue de Solidarité Active) in the department of Seine-Saint Denis increased 41 percent from 2008 to 2009.
26. An example of an SNG with an unbalanced budget is Seine-Saint Denis which, in April 2010, voted an unbalanced budget to protest the abolition of the professional tax and the reduction of transfers from the central government.
27. Compulsory expenditures include wages of local civil servants; SNG financial contributions to local-interest services; maintenance of the city hall, roads, and cemeteries; and debt services.
28. Acts No. 82-213 of March 2, 1982; No. 82-623 of July 22, 1982; No. 83-1186 of December 29, 1983; No. 85-97 of January 25, 1985; No. 86-972 of August 19, 1986; No. 88-13 of January 5, 1988; No. 90-55 of January 15, 1990; No. 92-125

of February 6, 1992; No. 93-122 of January 29, 1993; and No. 94-504 June 22, 1994. For an overview, see Bertucci (1995).

29. The National Court of Accounts and the Regional Courts of Accounts constitute a separate judicial branch in administrative-financial matters.
30. L. 1612-14 CGCT provides that if the projected deficit exceeds 10 percent of operating expenses for a municipality with less than 20,000 inhabitants, or 5 percent for other municipalities, the Regional Chamber of Accounts recommends measures, on request of the Prefect, to reestablish budgetary equilibrium within a month.
31. Fabrice Robert, *Les Finances Locales*, 2009, 158.
32. Pont-Saint-Esprit is a municipality of 9,523 inhabitants. The Regional Chamber of Accounts of Languedoc-Roussillon in 2006 began implementing several actions to cope with Pont-Saint-Esprit's financial distress, such as an audit of Pont-Saint-Esprit financial management during 1999–2005.
33. The 1962 Public Accounting Regulations specify this principle of separation.
34. In the area of education, an important public function in France, Public Accountants are appointed by the Minister of Education. Otherwise, there are Public Accountants at the three SNG levels (municipalities, departments, and regions); they are, respectively, the *receveurs municipaux* (municipal public accountant), the *payeurs départementaux* (departmental public accountant), and the *payeurs régionaux* (regional public accountant).
35. The State Treasurer services also audit local public finances management of only municipalities with a population under 3,500 inhabitants whose operating revenues are under €750,000.
36. These two public financial institutions are *la Caisse des Dépôts et Consignations* and *la Caisse d'aide à l'équipement des collectivités locales.*
37. This figure includes SNGs and public-private enterprises.
38. Article D. 1511-32 of the *Code Général des Collectivités Territoriales.*
39. Article D. 1511-34 of the *Code Général des Collectivités Territoriales.*
40. Article L. 1614-4 of the CGCT.
41. Law of May 15, 2001, *Nouvelles régulations économiques* (New Economic Regulations), authorizes SNGs to issue short-term negotiable debt instruments with a minimal nominal value of €150,000 and a maximum duration of one year. These instruments are not considered to be long-term debt.
42. Decree No. 2005-601 of May 27, 2005 modifying Decree No. 2004-15, relying on Directive No. 92/50 of June 18, 1992.
43. Circulars of September 6, 1999, and May 15, 2000.
44. The successor company is Dexia.
45. Based on interviews with Valérie Montmaur, S&P; and Gilbert Payan, municipality of Aubagne.
46. Most French SNGs do not access the capital market; hence, they are not rated.
47. Since the majority of French SNGs do not access the capital market, relying mainly on bank loans, the rated SNGs may represent the most creditworthy borrowers.

48. An example of this fiscal risk can be seen in the municipality of Levallois-Perret. In the late 2000s, the city faced acute financial woes. The costs of running the city increased much more rapidly than receipts, due mostly to increased investment and personnel expenses. Though there was room for raising taxes, the city's self-financing capacity in 2006 remained unchanged relative to 2002. The municipality relied increasingly on borrowing. The biggest source of contingent liability stemmed from urban development operations. The municipality owns, de facto, 80 percent of three public limited companies and 15–80 percent of another 40 commercial companies. Some SEMARLEP activities, such as real estate sales, are outside the competences of SNGs and their government-owned corporations. Yearly reports appear to contain insufficient information for the municipal council to understand either the true financial stakes of the group's activities or the indirect commitments and the risks flowing from them. Source: National Court of Accounts Report (2009b).
49. The National Court of Accounts 2009b.
50. This amount accounts for 58.4 percent of total SNG structured debt (see Crouzel 2011).
51. National Court of Accounts 2009b.
52. Statement of financial executive Wallace O. Sellers before the Subcommittee on Economic Stabilization of the U.S. House Committee on Banking, Currency and Housing, October 22, 1975, 1418. ("In England or France, it would be unthinkable for a major city to go bankrupt. In France, with a highly centralized system developed under Napoleon, the state exercises substantial control over the finances of SNG units.")
53. One example is the municipality of Saint-Étienne, whose heavy exposure to financial derivatives was discovered in 2008. Facing a skyrocketing debt in the 1990s, the municipality tried to smooth the payoff by actively managing the debt through structured products ("Saint Étienne: dégonflement programmé de la dette," *Les Echos*, July 7, 1994). The central government did not want to intervene because this could create a precedent of a moral hazard ("Pas de dérogation pour Saint-Étienne," *Les Echos*, April 15, 2009a). There were calls for a more structured legal framework and the creation of a "bad bank" in order to get rid of all the toxic products ("Saint-Étienne veut une régulation plus stricte qu'une charte," *Les Echos*, May 29, 2009b).
54. Cécile Crouzel, "La difficile évaluation des prêts toxiques," *Le Figaro*, December 15, 2011.
55. Garabedian, A., "Le puzzle des collectivités locales se met en place," *L'Agefi*, February 9, 2012.
56. This view is advocated by Michel Klopfer, an independent consultant who specializes in local finances (see Klopfer 1996).
57. Circulaire No. 92-260, Contrats de couverture du risque de taux d'intérêt offerts aux collectivités locales et aux établissements publics locaux, September 15, 1992. See also Fitch Ratings, *French Local Government's Structured Debt: Active Management or Speculation?,* July 15, 2008b.

58. Article 120-3 of the General Accounting Plan.
59. *Les Echos*, "Emprunts des collectivités locales: le gouvernement cherche à rassurer," November 3, 2008.
60. Joël Cossardeaux, "Emprunts toxiques: élus locaux et banques font le ménage pour l'avenir," *Les Echos* May 29, 2009.
61. Executive Order No. 2008-1078 of October 22, 2008.

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7

Hungary: Subnational Insolvency Framework

Charles Jókay

Introduction

Hungary's experience with municipal insolvency is unique. It has one of few insolvency systems in the world where municipal insolvency can lead to a court-supervised "bankruptcy and reorganization" process that is led by an independent receiver or trustee.[1] The Municipal Debt Adjustment Law (Law XXV, 1996) was enacted a few years after the start of economic and political transformation in Hungary, and studies have examined its results (for example, Jókay, Szepesi, and Szmetana 2000). Hungary's experience has influenced similar legislation in Estonia, Latvia, and Romania in the first half of the 2000s, although the court-supervised system has not been emulated entirely.

A review of the Hungarian experience will add to the understanding of a subnational insolvency system, particularly with respect to the potential role of an independent judiciary, importance of properly allocating risk, ensuring the viability of local government in delivering vital services, and balancing the needs of creditors and debtor. Hungary's case emphasizes the importance of drawing a distinction between the municipality itself, and the private or publicly owned enterprises contracted to perform vital public services. A further distinction involves whether or not the municipality provides an explicit guarantee to private or publicly owned enterprises and whether or not these enterprises perform any legally mandated public function. This distinction affects the potential recourse of lenders to the municipality.

Recent examples in Hungary demonstrate implications for both the owners—that is, municipalities and enterprises—that have mutual and often contradictory effects on each other. According to the Hungarian experience, only municipalities are covered by municipal bankruptcy legislation, and all corporate entities regardless of ownership and type (limited liability, share companies, for profit, or nonprofit) fall under the jurisdiction of corporate bankruptcy law.[2] The provision of guarantees by municipalities, and the obligation of municipalities to have certain services delivered regardless of the form of delivery complicate these relationships. The Municipal Debt Adjustment Law extends the obligations of providing public services to the municipality itself if the company (private or public) that provides a particular municipal service such as water or public transportation goes through bankruptcy proceedings under the commercial code.[3]

This chapter analyzes the Hungarian municipal insolvency experience since 1996. The chapter also analyzes issues that have emerged, such as treatment of municipal enterprises that may perform a mandatory function but operate under the commercial code, and others such as guarantees and hidden contingent liabilities that have been identified in insolvency cases.[4] The chapter presents the historical context for the adoption of the Municipal Debt Adjustment Law and the implementation experience, describes the fiscal functioning of local governments and their responsibilities, and identifies issues to be dealt with going forward. A review of the Hungarian experience could offer lessons for other countries with a relatively decentralized local government system.

The scope of this chapter does not extend to enterprises in which the national government is the sole or dominant shareholder. For this reason, companies such as the national railways (MAV) and the power grid (MVM) will not be discussed. Municipally owned enterprises are not governed by any special legislation of their own and belong under the corporate regulatory regime regarding taxes, accounting, and bankruptcy. These entities are treated as corporate borrowers by lenders, and in most cases, a municipal guarantee is also sought. Such entities do not fall under the Municipal Debt Adjustment Law but can have a direct impact on the financial viability of the municipality through called guarantees (the creditor submits a claim to the guarantor), and invoked service provision obligations. A countervailing tendency is that municipal enterprises are consolidated into holding companies that amass profits and assets, all of which are off the balance sheet of the owner, except through the nominal value of shares that appear as "share assets" on the balance sheet of the municipality.[5]

On corporate bankruptcy vs. municipal debt adjustment, the rules on the effect of both insolvency laws are clear. For cases of insolvency of a municipal government as an entity, the Municipal Debt Adjustment Law applies with all its practical consequences: the debts should be partly or entirely settled, and the entity shall be able to provide services. Should any of the business associations that are rendering public utility services become insolvent, the corporate insolvency law (Law XLIX) applies. There is an option for pursuing the business activity for a definite time provided that the company in insolvency proceedings is able to pursue its activity without any losses, and the creditors agree.

A country's macroeconomic framework impacts the financial health of municipal governments, primarily through the cost of borrowing, fiscal transfers, and economic growth (Canuto and Liu 2010). This chapter discusses how the 2008–09 global financial crisis impacted local government finance in Hungary, although the focus of the chapter is on the subnational insolvency system, which has its own distinct issues, such as the design of the framework and the priority structure for resolving competing claims. A more detailed analysis of the macroeconomic challenges facing the country, though important, is outside the scope of the chapter.

The rest of the chapter is organized as follows. Section two reviews the macroeconomic and institutional context for the development of the Municipal Debt Adjustment Law. Section three presents the structure of subnational governments and their finance. Section four details the subnational borrowing framework with a focus on ex-ante regulations. Section five examines subnational insolvency procedures and how the law deals with different types of debt instruments and debtors. Section six reviews insolvency implementation experience. Section seven draws lessons and summarizes ongoing discussions in Hungary on potential reforms to strengthen subnational insolvency procedures, in the context of broader institutional reforms. Section eight presents conclusions.

Macroeconomic and Institutional Context for the Development of the Municipal Debt Adjustment Law

Roots in "reform communism." Hungary's economic and political transformation that culminated in free elections in April 1990 had roots in the "reform communism" of the 1980s. Hungary's first significant transformational laws were passed in the late 1980s before the systemic change that shook Central Europe during 1989–90. The banking system became multitiered in 1987, when the central banking functions were separated from the commercial and retail banks, all still owned by the state. The first international banks to appear in Hungary after nationalization in the late 1940s were Citibank and Unicbank, the precursor to Raiffeisen, both of which appeared in the 1980s. A form of Party cadre-lead self-privatization[6] began in 1988–89, as well. Direct investment and limited currency liberalization for both industry and households were in place by 1990. Following Hungary's free elections in early 1990, all of the major sectoral and framework laws were quickly passed. These included the Law on Local Government, and laws on the stock market, property transfer, banking, privatization, pensions, enterprises, elections, media, accounting, and the state budget system.[7] Although some of these laws have been amended in minor ways, they remain in effect (see box 7.1).

Box 7.1 Major Acts Regulating the Municipal Sector, Hungary, 1990–2011

1990: Law on Local Government created municipalities out of the existing local council system
1991: Property Transfer Act assigned and returned most state property on municipal land to municipalities, transferred other state property to the local level, transferred "council" property to newly formed municipalities
1995: Modifications to the Law on Local Government imposed borrowing limits based on a share of net own revenues
1996: Municipal Debt Adjustment Law
1996: Debt service limit added to the Law on Local Government
2011: Law on Local Government (effective January 2012)

True self-government. The 1990 Municipal Act and various constitutional provisions guaranteed that Hungarian municipalities were considered an equal and unsubordinated branch of government. Hungarian local self-governments were granted important freedoms to engage in business activities, impose local taxes, plan their own development, and borrow in an entirely unregulated manner until 1995. The 3,194 self-governments, which range from villages of a few dozen people to the capital city of Budapest, have essentially equal status, rights, powers, and duties. The national government operated public administration offices at the county level until 2012 to check compliance with procedures and administrative requirements, but they are not allowed to comment on the substance of municipal decisions and budgets provided to them. The State Audit Office, independently of the government and reporting directly to Parliament, does engage in performance, compliance, and financial audits on an as-needed and random basis; however, it can only recommend changes to local leadership and file formal charges with the prosecutor's office. The State Audit Office has no investigative powers.

In this environment, Hungarian local governments were, until 2012, not required to seek permission of a ministry to engage in borrowing and had the right to freely choose a bank. Attempts to have an integrated single treasury account do not work politically in Hungary, given the resistance of commercial banks, the municipal sector, and the persistence of the liberal tradition underlying the Law on Local Government. Notwithstanding that, each municipality has a treasury account to net out transfers and shared taxes received from, and payroll taxes and the value-added tax (VAT) owed to, the central government. These treasury accounts are only for clearing, while all municipalities keep their excess cash in commercial banks and savings cooperatives.

Macroeconomic context. In the context of the rapid collapse of the Soviet markets and of trade among the former Council for Mutual Economic Assistance states, by 1994 Hungary suffered a collapse of its industrial sector, resulting in high unemployment, energy price shocks, and other adjustment costs. In 1994, inflation was 15–20 percent. Municipalities, without any restriction on their investment, cash management, and borrowing activities, began to behave irresponsibly, and engaged in for-profit businesses such as hotels and industrial parks.

Municipalities engaged in an investment boom, borrowing at high interest rates from the handful of state-owned banks. Most of this investment was stimulated by grants from the central government for vital environmental investments in safe drinking water, sanitation, and wastewater treatment.

Threat of soft budget constraints. In a strange role reversal, in 1993 and 1994, representatives of state-owned banks lobbied for special bailouts for their clients, while the Ministry of Interior faced the first major policy challenge to Hungary's liberal Municipal Act: bailouts would lead to more bailouts, and economic freedom also meant facing the consequences of bad decisions on the part of both lender and borrower. Unfortunately, at that time, there was no framework in place to deal with defaults by municipalities, and, notwithstanding pressure from those few in trouble and their banks, policy makers and bureaucrats faced a serious dilemma. Solving the problem of irresponsible lending and borrowing has two possible solutions: restricting municipal borrowing by requiring higher-level approval and a stricter debt limit formula, or, alternatively, a no-bailout policy combined with no higher-level ex-ante or ex-post oversight.[8] The second approach would not restrict debt issuance beyond the existing debt service formula, but in addition to a no bailout policy would create a legal framework for debt adjustment and restructuring similar to that in the corporate sector. In 1994, design objectives for a debt adjustment procedure included the following:

- To maintain municipal autonomy from the central government by not instituting a permitting process
- To assure that mandatory tasks would not be endangered by the consequences of failed projects or irresponsible borrowing
- To offer assurance to lenders and other creditors that their claims would be adjudicated fairly[9]
- To protect municipal assets classified as being essential for providing public services (schools, the town hall, parks, and so forth)
- To encourage voluntary agreements among the creditors and borrowers, while supporting structural changes at the local level needed for long-term fiscal viability.

Given the unrestricted freedom of local governments to manage their assets and budgets (within the constraints of shared taxes, transfer payments, and local tax capacity), the central government faced the possibility of potential contingent liabilities in the form of "moral obligations" and political pressure to fund local mandatory tasks. Or worse, the central government faced the possibility of directly carrying out mandatory local tasks if local governments failed to. By the end of 1995, several local governments lobbied for and received one-time grants from the central government's general reserves to resolve insolvency caused by mismanagement and excessive debt.[10] This precedent created a moral hazard and gave no incentive to the local governments to make more reasonable investment decisions. The major lenders began to lobby the central government for "one time" bailout assistance to their clients.

Toward institutionalized debt adjustments. By 1995, Hungary's deteriorating macroeconomic situation and adjustment resulted in a currency devaluation and real cutbacks in spending and other restrictions. The problem of indebted local governments became more serious. Municipalities began to borrow to finance short-term operating deficits and nonmandatory infrastructure, creating substantial refinancing risks given that the short-term interest rates on Treasury securities were between 25 and 30 percent during 1994–95. The restrictions on bailouts and the use of transfers cited above were not adequate to withstand the political pressure on the central government to provide emergency funds to assist potentially insolvent local governments whose poor investment decisions were endangering the provision of mandatory public services. Without the political will or ability to tightly control local government borrowing and business practices by constitutional and legislative fiat, the Hungarian government decided to propose a municipal debt adjustment law that could be invoked if prudence and other preemptive measures failed.

Structure of Subnational Governments and Their Finance

Structure of Subnational Governments

Hungary is a unitary (centralized) state, with three levels of elected government and appointed administration: central, counties, and municipalities. Local governments that are in full harmony with the European Charter of Local Government[11] can be found only at the level of municipalities. Each village, small city, large city, Budapest district, and the city of Budapest itself is called a municipality, regardless of whether it has a legal status of village, town, or city. For the purposes of this chapter, a Hungarian municipality is one of 3,196 settlements that has its own mayor, council, budget, and assets, as well as mandatory duties and full authority to pass local ordinances allowed by law.[12] No municipality is subordinate to any other municipality, and only an act of parliament can dissolve an assembly or involuntarily combine several jurisdictions into one.

Only 10 percent of municipalities have a population over 5,000, and only 5 percent have a population over 10,000. By international comparison, the average size of a Hungarian local government is relatively small. Notwithstanding the small size of local governments, they are responsible for a significant number of tasks. The budget of all local governments (including counties) amounts to 12–13 percent of gross domestic product (GDP), which is average for Europe.[13]

The development of the Hungarian system complied with the requirements of the European Charter of Local Government. The legal foundations of the present framework are the Constitution (1989) and the 1990 Law on Local Government. They define the economic basis of the independence of local governments. These include municipal own-source revenues, their assets, and grants from the central government. Local governments have considerable autonomy in local decision-making processes. The central government has limited authority over them. The Fiscal Stability Act (No. CXCIV, Law of 2011), effective January 1, 2012, generally binds the borrowing of the municipalities to the permission of the central government.

The mandatory duties of Hungarian municipalities numbered in the hundreds until the end of 2011. The Law on Local Government, and dozens of acts regulating sectors such as education, health, social welfare, and so forth, add to the duties.[14] These specific functions, such as primary and secondary education and many public administration tasks, will be centralized effective 2013. It is too early to forecast the fiscal impact on the municipal sector.

This list of mandatory tasks, regardless of the size and economic potential of municipalities, is a source of many fiscal stresses that are outside the scope of this study. In most cases, the delivery method and standards of performance for these tasks are not specified. Therefore, municipalities are free to contract out, hire private providers, form their own firms, and seek forms of cooperation with the nonprofit sector and with neighboring municipalities in associations authorized by specific legislation. Municipalities have great autonomy by law in local decision making.

Municipal services are delivered by many types of legal entities, budgetary or subject to the commercial code. Municipal services of all types are delivered by the municipalities' own departments, by public bodies that are subjects of the municipal budget, by commercial code enterprises wholly owned by the municipality and established for one specific service, by enterprises with mixed municipal and private ownership, by contractors, by public-private partnership (PPP) entities, by concession companies (water, wastewater, solid waste), and by nonprofit corporations that may or may not be in municipal ownership, among others. The relationship of these entities to the municipality is governed by founding acts, by concession and procurement law, by contracts, and by the type of service being performed on behalf of the municipality using public funds and user charges.

Sources of Subnational Finances

Capital investment funding. Since European Union (EU) accession in 2004, Hungarian municipalities have relied almost exclusively on various grants that originate from EU sources, since domestic capital grants have all but been eliminated. These grant structures typically require cofinancing; municipalities need to cofinance 20–50 percent of project costs. The source of financing may be from asset sales, accumulated savings, and from bond issues and bank loans. The central government budget provides aid for municipalities to supplement their own resources, such as local taxes and fees. The "EU Own Resource Subsidy," which is a part of central government appropriations, lends assistance to municipalities in disadvantage for the purpose of cost sharing required by investments aided by the EU.

There are four types of municipal revenues[15]:

- Own current revenues, such as local taxes, user charges, and other nontax revenues such as income of municipal institutions (catering fees), rental income, and interest and dividends, which account for about one-third of municipal revenue.

- Own capital revenues, such as sales of real estate and other tangible assets, sales of shares in enterprises, and dividend earnings, which account for about 10 percent of municipal revenue.
- Intergovernmental grants that are either earmarked or freely usable, both for mandatory services, which account for about 15 percent of municipal revenue.
- Minor tax sharing of the personal income tax and the full amount of the motor vehicle tax (the capital city and the towns with county status also share the duty revenue), which account for about one-quarter of municipal revenue. Both the motor vehicle tax and the personal income tax share will become a fully central source of revenue as of 2013.

The formulas for tax sharing and grant design have shown great volatility during the last two decades. As a result, it is difficult for local governments to exercise strategic financial management, considering the risk that the annual central government budget will alter normative grant calculations to their disadvantage.

The local business tax (essentially a tax on gross turnover set at 2 percent) accounts for 84 percent of local taxes collected, followed by a building tax at 11.2 percent.[16] The turnover tax is vital in that it is the primary source of cash to finance debt service. All other taxes, including the sojourn tax (*hotel tax*) and minor taxes on the area of land and buildings, are not substantial sources of revenue. Budapest collects more than half of the total business tax for all municipalities, and most small municipalities impose only minor communal and property taxes, since they have little economic activity. In the larger municipalities that are categorized as cities, local taxes account for no more than 20 percent of total revenue. Villages collect virtually no local tax, and only less than 5 percent of their budgets are funded from own-source revenues, including all fees, local taxes, and business income.

De jure financial freedom vs. de facto central control. Hungarian local governments have considerable de jure financial freedom. In the euphoria of the transition from a planned economy to a market economy, a highly decentralized and undersupervised local government system was created. De facto fiscal independence of local governments is contradictory, at a minimum. First, 60–70 percent of their funds actually depend on the annual decision on the central budget. Second, the government grants paid to finance their compulsory functions cover a decreasing portion of the costs of these services. An increasingly higher proportion of the local governments' own revenues finances the centrally mandated functions. As a result, the most effective instrument for the central government to exercise influence on the functioning of local governments is to regulate tax sharing and grant design.

Restrictions on Debt Collateral

Municipalities in Hungary own significant portfolios of assets, such as buildings, land, shares in enterprises, equipment, and financial investments. These properties are required by the Municipal Act to be categorized by the local administration applying the law, as being (a) core, that is, essential for the delivery of a public service and hence unavailable for sale or use as collateral; (b) essential but negotiable; or (c) nonessential and fully negotiable. In most cases, it is not the type of property that defines its negotiable or essential status, but rather its function in delivering mandatory services. In essence, with a few exceptions such as historical monuments, archives, museums, parks, and so forth, the local council may choose to reclassify property as being negotiable if its underlying function changes. This distinction of core vs. noncore property is critical in determining whether an asset is available as collateral, and whether it can be sold during a municipal insolvency proceeding. Besides "core property," certain sources of revenue are not available for debt payment. These are normative state transfers, the personal income tax, and other shared taxes. The turnover tax (84 percent of local taxes collected) is the primary source of financing debt service.

Impact of the 2008–09 Global Financial Crisis

After a 6.8 percent drop in GDP in 2009, Hungary's GDP grew modestly in 2010 and 2011. Inflation declined from 7.9 percent in 2007 to 3.9 percent in 2011. The ratio of fiscal deficit to GDP improved during the period.[17] With high exposure to foreign currency debt at the state, household, and enterprise levels, Hungary's gross external debt ratio to GDP rose from 105 percent in 2007 to 140 percent by 2011.[18] These macro tendencies impacted local governments indirectly through rapid devaluation[19] and higher risk premia for borrowing in foreign currency, since domestic currency borrowing by local governments was not significant during this period; prevailing domestic interest rates continued to be a multiple of euro or Swiss franc rates.[20]

Hungary's local government debt stock[21] (in bonds) jumped from 212 billion forint (US$1.23 billion) in 2007 to over 555 billion forint (US$2.3 billion) in 2011. Bond issuances increased on a net transaction basis annually during 2007–10. However, net bond issues were over 325 billion forint (US$1.35 billion) from 2007 to 2011, with an over 200 billion forint (US$830 million) increase as the result of revaluation due to the strong Swiss franc. On the loan side, loan debt stock increased by only 200 billion forint (US$830 million) during this period, with actual declines in 2008 and 2011 due to prepayment. In some cases, revaluation of existing debt stock was large enough to counteract changes in net transactions (for example, from 2008 to 2011, revaluation overwhelmed repayment of loans and increased debt stock).[22]

Hungarian municipalities face three risks from the banking and fiscal crisis in Europe. The first risk is currency risk and rapid devaluation of the forint, a risk they cannot hedge since all of their revenues are in domestic currency. Over 80 percent of municipal bonds are denominated in Swiss francs and half of bank loans are in euros. The second risk stems from a decline in fiscal transfers, which has affected their revenues used to deliver mandatory services and make payments. From 2007 to 2011, operational transfers dropped 23 percent in nominal terms.[23] The third risk is the impact of slower economic growth on own revenues, which are the only funds available for debt service.

Subnational Borrowing Framework: Ex-Ante Regulations

Subnational Debt Market

Ex-ante rules on borrowing. Hungary's debt regulations operated under several important rules and laws that regulate the economic and budgetary functions of local government. These controls emerged during 1990–2002, but most of them are in basic laws and were in effect by 1996, when the debt adjustment law was passed. Prior to 1995, there were no restrictions on municipal borrowing. In 1995, a debt service limit was introduced that was based on a restricted definition of funds that were available for debt service. Only own revenues (local taxes, local fees, business income, earned interest, rental income, and so forth) would be available for debt service, only after all mandatory services were paid for, and only 70 percent of such surplus was available calculated on the last completed budget year.[24] The formula was difficult to enforce since guarantees, contingent liabilities, PPP payments, and grace periods could not be taken into consideration, and it was built on the assumption that full operating costs were actually known, and the surplus would be consistent over time. There is no early warning system, since the cash accounting system is delayed, inaccessible, and can hide deferred payments and contingent liabilities with ease.

The Law on Local Government (2011), which went into effect in January 2012, stipulates a new kind of limit calculation that essentially restricts debt service to half of annual own revenues (excluding all transfers and shared taxes and capital revenues). There is no stock limit, and, more significantly, each borrowing or bond issue must be approved by government decision, a practice that did not exist between 1990 and 2011.

General characteristics of municipal banking and lending. OTP, the former monopoly state-owned savings bank, privatized in 1995, and the network of savings cooperatives (owned by depositors) dominate about 70 percent of accounts management for municipalities in Hungary. The rest of the commercial banks, all of them foreign-owned subsidiaries or representation offices, are more successful in lending and bond investing, since OTP's dominance in lending volume is much lower, at about 50–55 percent of long-term lending. There are no public issues of municipal debt. Almost all bonds are held by the arranger bank, the same banks that dominate term lending and accounts management, and only a handful of bonds have been sold to investors based outside of Hungary. Even though almost all bonds (some 80 percent) are *denominated in Swiss francs and euros*, they are held by Hungarian-registered banks. Loans are also heavily in euros and Swiss francs, but mainly from Hungarian-registered banks, since Hungary's legislation allows public bodies to borrow in any currency.[25]

Bank management of local governments' accounts. Prior to its privatization in 1995 and public offering in 1997, OTP, known as the National Savings Bank, had a monopoly on managing municipal bank accounts and was responsible for nearly all lending and other financial services offered to the sector. Municipalities may have as many banking relationships as they wish, as long as they maintain one primary account for their transactions.[26] The OTP's primary banking relationship with the municipal sector until 1995 earned benefits for the bank in terms of being familiar with municipal management, having a monopoly on information on the finances of the client, and essentially having the right of first refusal on any new loan, overdraft product, or even bond issuance. Savings cooperatives, with extensive but localized networks, took business from OTP in the smaller towns and larger villages.[27]

The separation of primary banking from other financing activity is very significant, and the resulting competition among banks can explain, in part, the favorable, almost irrational terms offered to Hungarian municipalities in the lending boom between 2006 and 2008, which came to an abrupt ending during the financial crisis as foreign headquarters restricted lending. EU accession in 2004 meant full adoption of EU procurement directives on financial services. The EU exempts certain services, such as the issuance and sale of securities and other financial instruments, from procurement, and this provision was inserted directly into Hungarian procurement rules. Since no formal procurement is needed, bond issuance enjoys a significant advantage over bank loans, and a series of intense competitive negotiations and offers can be executed in a short time.

Municipal Debt Composition

Changes in debt stock. Hungarian municipalities' long-term debt remained modest during the decade 1990–2000, not exceeding 100 billion forint (about US$600 million at prevailing exchange rates) until 1998.[28] This is in contrast with indirect liabilities such as vendor loans and long-term service contracts. Between 2000 and 2009, bank borrowing increased by a factor of 6. Bond issuance went from zero in 2004 to a stock total of nearly 500 billion forint (US$2.5 billion) in 2009. Significantly, short-term debt amounted to a quarter of total debt by 2009, a sign that serious arrears and loans from vendors had accumulated in the sector, with short-term cash flow loans essentially financing hidden operational deficits. The only restriction on short-term debt is that it has to be zero by the last day of each year, a practice that does not eliminate the rollover. As shown in table 7.1, the total long-term debt of Hungarian municipalities reached 4.5 billion euros by March 2011, but the share of bonds fell to 48 percent. Table 7.1 also reflects changes in the Hungarian forint exchange rate compared to the Swiss franc and euro as well, so the relative share of loans and bond issues also depends on the cross rate between euros and Swiss francs—since 80 percent of bonds are issued in Swiss francs, while only half of loans are in euros.

The aggregate data shown in table 7.1, however, do not reflect the extent of the liabilities of the municipalities, since given guarantees do not show up in financial statistics reported to the National Bank, and do not appear in balance sheets unless those guarantees are actually paid. Debt stock could exceed total annual revenues by several factors, when the most common debt stock limitation in use in European transition countries is a debt stock limit of 50–100 percent of the annual budget. This budget-related debt stock limit is a rule of thumb, since property taxes, property valuations, and other measures related to assessed and taxed value are not informative in this context.

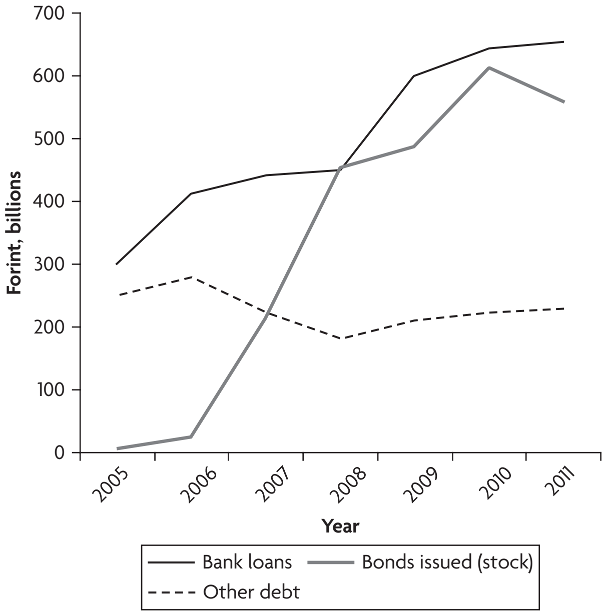
Figure 7.1 shows neither guarantees given by municipalities nor other contingent liabilities. Furthermore, enterprises owned by municipalities are also borrowing as commercial entities, and their liabilities and assets do not appear on municipal balance sheets, except in the

Table 7.1 Debt of Hungarian Municipalities Calculated at Prevailing Euro Exchange Rates

National bank financial accounts				
Municipal debt expressed in euros				
	Long-term bonds (in thousands)	Long-term loan (in thousands)	Total long-term debt (in thousands)	% of long-term debt in bonds
2003	22,800	730,000	752,800	3.03
2006	100,000	2,150,000	2,250,000	4.44
2007	83,399	1,707,000	1,790,399	4.66
2008	1,735,000	1,660,000	3,395,000	51.10
2009	1,775,000	1,660,000	3,435,000	51.67
2010	2,071,890	2,177,900	4,249,790	48.75
2011 1Q	2,188,000	2,310,000	4,498,000	48.64

Source: Author's calculations based on National Bank of Hungary "Financial Accounts," http://english.mnb.hu/Statisztika/data-and-information/mnben_statisztikai_idosorok/mnben_elv_net_lending/mnben_0601_osszefoglalo_informaciok), published quarterly; and official exchange rates published daily.

Figure 7.1 Bonds, Bank Loans, and Other Debt, Hungary, 2005–11



Source: National Bank financial statistics published quarterly; http://english.mnb.hu/Statisztika/data-and-information/mnben_statisztikai_idosorok/mnben_elv_net_lending/mnben_0601_osszefoglalo_ informaciok.

form of subscribed or base capital, a figure that often represents only a small fraction of the balance sheet of these enterprises. Various studies by the State Audit Office have estimated that the guarantees given by municipalities not recorded as explicit debt anywhere have an estimated value equal to 7 percent of total liabilities, or about 70 billion forint at the end of 2009.[29] Thus, total municipal debt is larger when including guarantees of enterprise debt that do not show up in the financial and budget reports filed with the State Treasury.

The borrowing began to increase in 2000 in anticipation of EU accession in 2004. That borrowing was used to finance environmental and other infrastructure projects, while the bond issuance boom that started in 2006 was a function of the availability of structural funds, inexpensive lending in Swiss francs and euros, and a strong forint, combined with the realization that all bond issuances would be exempt from public tendering.[30]

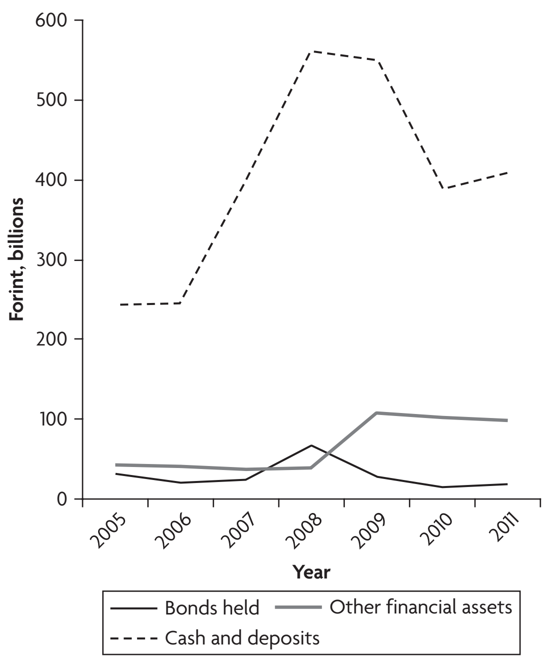
Exposure to currency risk. Figure 7.1 shows a nearly 19 percent increase in bond debt stock in the first nine months of 2010. Over 86 percent of that approximately 90-billion-forint (US$50-million) increase in bond debt stock was due to "revaluation." During that period, the Swiss franc gained 19 percent and the euro appreciated 23 percent against the forint. Since 80 percent of bonds issued are denominated in Swiss francs and euros, the bond debt stock of Hungarian municipalities increased by 19 percent in nine months. This highlights the exposure of the municipal sector to currency risks in debt service payments in late 2010 and early 2011, as the bonds with three-to-five-year grace periods issued during the 2007–08 boom started to incur principal payments. This annual capital repayment was estimated at 50 billion forint (US$250 million) on an aggregate basis. Again, the microlevel impact of capital repayment at Swiss franc exchange rates that were nearly 50 percent higher in 2010 than they were in 2007 could be devastating.[31]

A common explanation for the boom in bonds from 2006 to 2008 is that interest rates offered on these Swiss-franc-denominated bonds were about a third of the forint rate available at the time. The forint was appreciating during 2005–08 for the most part against the euro and the franc; thus, municipalities played arbitrage with higher forint deposit rates and low Swiss franc interest rates on their debt. Another factor was the ease with which competitive tendering of bonds could be avoided, leading to fierce negotiations over basis points. Banks could not offer ever lower Swiss-franc interest rates, so they began to negotiate the terms of the bonds, for example, extending the maturities to 20–25 years, and adding three-, four-, and five-year grace periods on principal payments. The market rumors that the government would move to restrict municipal borrowing caused a rush to accumulate borrowed cash and to invest it at temporarily favorable rates, that is, arbitrage.[32]

During this same period, municipalities accumulated cash and deposits that were equal to 40–60 percent of their total long-term debt. Bond proceeds undergo less routine monitoring than do bank loans. The cash earned interest in foreign currencies, while the grace period on the bonds gave a false sense of liquidity. Restrictions on municipal borrowing were too risky politically to be enacted in the annual budget.

The accumulation of cash, which almost doubled between the end of 2005 and 2009, is not justified by other uses such as payment of short-term loans, vendor loans, or other accounts payable, as figure 7.2 indicates. This means borrowed money was in part deposited in the banking sector for use in later periods. Taking into account changes in fixed assets, due to both sales and the completion of new projects and the revaluation of existing assets, a portion of borrowing has certainly been "consumed" for operational expenses, and not invested. The figures in this section are all aggregate, and include the debt of Budapest the capital and its 23 separate districts; thus, these trends will apply in differing degrees to each type and size of municipality. Figure 7.2 shows liquid financial assets of about 600 billion forint in June 2010. Figure 7.1 showed all forms of debt, including short-term debt, at over 1,400 billion forint. When liquid financial assets are dropping, the amount

Figure 7.2 Cash and Liquid Financial Assets, 2004–11



Source: National Bank financial statistics published quarterly, http://english.mnb.hu/Statisztika/data-and-information/mnben_statisztikai_idosorok/mnben_elv_net_lending/mnben_0601_osszefoglalo_informaciok.

available for anticipated rises in annual debt service becomes scarcer, perhaps eventually inducing an insolvency situation at the macro level.

These systemic risks, however, have so far *not* led to a bankruptcy procedure. Cash on deposit may be used to fund current deficits, to pay down debt, to make investments in fixed assets, or a combination of these. Thus, cash on deposit is a stock of money that may or may not be used. The operational deficit or surplus thus is entered only when the accounts are closed. During a budget year, cash on hand from previous years can be used for either current or capital spending. That cash stock may change due to operational deficits, surpluses, or new borrowing that is deposited and not used within a current budget year. Cash on hand can thus cushion crisis years and finance current deficits, and thus can have both positive and negative effects.

Subnational Insolvency Framework

Why a municipal insolvency act? During the 1994–95 debate on the creation of the debt adjustment law, policy makers in the Finance and Interior Ministries and experts concluded that if the state is not willing to administratively or legislatively control municipal borrowing, then a legal framework would need to serve the following policy goals:

- Prevent and preempt municipal defaults with respect to any lender, bondholder, or vendor
- Provide clear administrative and legal procedures for affected creditors
- Provide reorganization and workout procedures
- Make clear that the national government will not guarantee local borrowings or provide bailouts[33]
- Maintain essential public services
- Allow for expansion of borrowing as local taxes and revenues increase
- Discourage irresponsible borrowing and lending though municipal debt adjustment, combined with preemptive reorganization, budget cutbacks, and some emergency funding from the state.

The Municipal Debt Adjustment Law passed with 82 percent support in the Parliament, and went into effect in April 1996.

Subnational Insolvency: Procedural Steps

Procedural phases in the Municipal Debt Adjustment Law. The Hungarian Municipal Debt Adjustment Law specifies a procedure consisting of seven major phases:

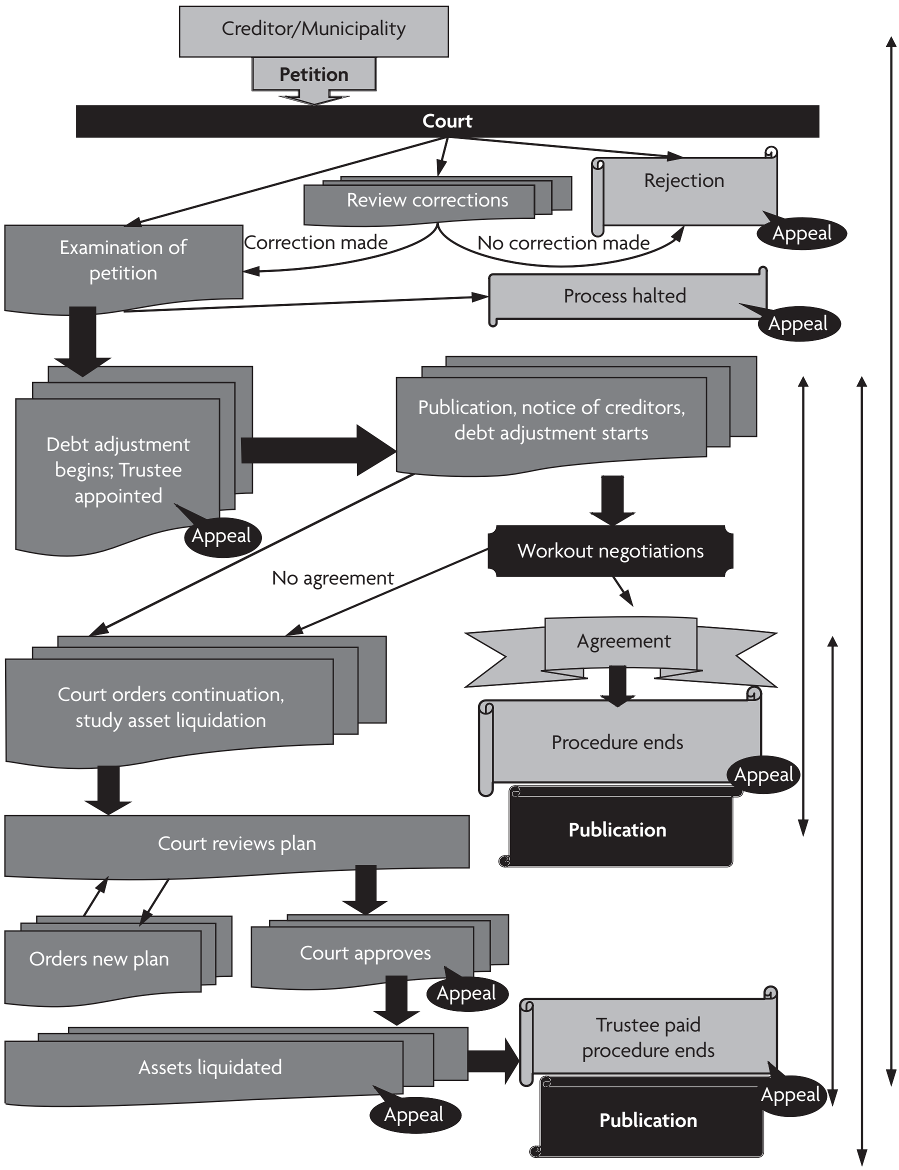
1. Initiation of debt adjustment procedure
2. Court review of the petition
3. Creating a debt adjustment committee
4. Adoption of budget developed for financial crisis
5. Formulating the financial reorganization plan and the proposed agreement
6. Debt agreement negotiations
7. Asset liquidation if no agreement is reached.

Initiation (1). If a municipality does not pay an acknowledged obligation to a creditor, vendor, or other party, documented either as an invoice or a court order to pay, within 60 days of the due date, the mayor is obligated to notify the city council and to petition the County Court[34] within eight days. If the court agrees that the municipality is truly in a crisis situation and cannot meet its obligations, it declares the debt adjustment process's initiation, and certain obligations are then imposed upon the mayor and the city council, and a separate set of actions is required of the creditors. A creditor may also petition the court if a municipality is in default, that is, more than 60 days late in paying an obligation.[35] The court may reject a debt adjustment petition if it determines that the obligation can easily be met with existing assets and cash flow. The mayor faces strict financial sanctions as a private person if a debt adjustment process is not initiated due to delays on his or her part (see figure 7.3).[36]

Court review of the petition (2). If the court finds that the conditions of insolvency are met—that is, any financial obligation is late 60 or more days—it decrees the commencement of the debt adjustment procedure or can terminate the procedure. The declaration by the court to start the debt adjustment process is posted in the Enterprise Registry, an official document of the court, and public notices are placed in the appropriate newspapers and published electronically.

Creating a debt adjustment committee (3). Simultaneously with the public notice, the court appoints a trustee (called a "receiver" in the international context), and the municipality has eight days from the

Figure 7.3 The Debt Adjustment Process, Hungary



Source: Jókay, Szepesi, and Szmetana 2000.

public notification to form a crisis committee. The membership includes the mayor, the notary, the chair of the financial committee (in the absence of a financial committee, a council member), and a council member. The trustee serves as the committee's chair. The court appoints a trustee from a list of qualified bankruptcy trustees and liquidators maintained by the Interior Ministry.[37] These are all corporate bankruptcy experts with public sector training and budget sector qualifications. Some work independently, but most are affiliated with liquidation firms (see box 7.2).

Box 7.2 point "h" is significant in that the *trustee may void contracts and transactions it deems to be "grossly disadvantageous" to the municipality*. In other words, if closed-door negotiations between a creditor and the debtor involve the transfer of assets, the granting of additional mortgages, or other securities that hinder the rights of all the other creditors in a later workout negotiation, the trustee may ask the court to nullify transactions that took place up to a year before the formal filing.

Adoption of emergency budget (4). The municipality has 30 days from the decree to prepare an emergency budget that services only

Box 7.2 Powers of the Trustee: Article 14 (2) of Hungary's Municipal Debt Adjustment Law

Under the law, the powers of the trustee are as follows:

a. Review the financial management of the local government and make a finding as to the reasons for the insolvency.
b. Inspect all documents pertaining to local government assets.
c. Attend public and closed sessions of the local government and the committees that have bearing on local government assets.
d. Make motions regarding debt settlement, which are to be deliberated by the representative body or the debt adjustment (also called crisis) committee as a first priority on the agenda.
e. Initiate collection of the local government's accounts receivable.
f. Inform the creditors, if requested, about the local government assets and the debt settlement procedure.
g. Inform the head of the county/Budapest public administration office if the representative body does not meet its obligations as stipulated by the law.
h. Within 90 days of the decree, the trustee may, by filing a claim on behalf of the local government at the court exercising general jurisdiction, contest contracts and legal statements made by the local government or its budgetary organ executed within one year before the commencement date of the debt adjustment procedure if they are grossly to the disadvantage of the municipality.

mandatory tasks allowed by the law. These mandatory services, defined in sectoral laws as well, do not necessarily have to be performed by the municipality directly through one of its budgetary agencies. The trustee examines the legality and legitimacy of all decisions leading to the financial crisis, and makes recommendations to the court for criminal and civil prosecution, if needed. The trustee must cosign all payments made by the municipality during this period, and all creditors are notified in the Enterprise Gazette to file their claims. The notary (chief administrator) prepares the draft crisis budget by law within 30 days of the commencement date of the debt settlement procedure (box 7.3).

Box 7.3 Restrictions on a Municipality Undergoing Debt Adjustment in Hungary

From the date of the commencement of the debt settlement onward, the local government may not:

a. Make decisions through which it incurs additional pecuniary liabilities
b. Establish businesses
c. Acquire ownership in businesses
d. Service debts or other obligations assumed prior to the decree.

Within 30 days of the date of the commencement of the debt settlement, the mayor shall provide to the trustee:

a. A report on financing and the proposed method of implementing mandatory or optionally assumed local government duties and excising mandatory or optionally assumed local government powers
b. An inventory of, and an annual report on, the local government assets prepared as of one day before the date of the commencement of the debt settlement which includes, with adequate justification, the following categories: registered assets, assets necessary for performing and exercising duties and powers required by law, and assets that can be used to meet creditors' claims
c. A draft crisis budget
d. A detailed summary of proceedings in progress at court and before state authorities and a detailed summary of execution proceedings in progress
e. Contracts regarding local government assets that were concluded within a year before the date of the commencement of the debt settlement procedure
f. Detailed information on business organizations operating with the involvement of the local government
g. Detailed information on the financial situation, debts, and accounts receivable of local government institutions
h. Other requested documents that the trustee determines are needed to perform its responsibilities.

Financial reorganization plan and draft agreement (5). The council shall approve the crisis budget, and the debt adjustment committee draws up a reorganization plan and drafts an agreement for a compromise with the creditors. In addition to a detailed description of the financial situation of the local government, the reorganization plan includes proposals regarding the use of the assets that may be involved in the debt settlement and proposals for taking various measures to expedite the debt settlement effort, also indicating the level of income each of these measures yields to the local government.

Debt agreement negotiations (6). The trustee sends the reorganization program and the compromise proposal approved by the representative body to all the creditors, and invites them to negotiate the compromise.[38] A compromise may be concluded if more than half of the creditors having extant claims at the time of the decree date consent to it, provided that the total aggregate claims of these creditors amount to at least two-thirds of all the reported and uncontested creditors' claims. If the creditors were divided into groups in the compromise proposal, then at least a majority of the creditors in each group must consent to the compromise in bankruptcy.

Asset liquidation (7). If the debt adjustment negotiations fail to reach agreement or the city council fails to develop a crisis budget within 60 days, the court shall continue the debt settlement procedure according to the rules of the partition of assets by the court. No appeal of such an order is possible.[39]

The worst case scenario. If the debtor and creditors cannot come to an agreement 210 days after publication of the debt adjustment decree by the court, or more than 270 days have lapsed after nonpayment, taking into account time needed for public auctions of assets, the court can request the Parliament to dissolve the city council and call for new elections. At this time, criminal and civil prosecution can also take place. The entire process, including appeals, and if needed, public auctions of municipal assets, is set to take place within 270–300 days of the decree, depending on whether each actor—the municipality, the court, and the trustee—uses their full allotment of processing time.

Types of Debt and Their Treatment during Debt Adjustment

Three types of municipal debt are significant: loans (secured and unsecured), bonds, and arrears (preferential arrears such as taxes and salaries and nonpreferential arrears). What matters in the debt adjustment process is whether the particular type of debt is preferential or not. Although the implicit (service-obligation-based) guarantees are not covered by the debt, once the guarantees are called, the law does cover them.

Typically, loans taken by local governments are secured by real estate mortgages. The pledged property may even be a movable asset, or, less frequently, securities or business shares. The guarantee may also be granted as a security either on a cash-flow basis or based on offering other forms of collateral. Issuing bond securities provides an opportunity to raise funds that is simpler and easier than borrowing from a bank. The hierarchy of preference rules governing secured claims does not apply to the enforcement of claims based on bonds. The enforcement of claims arising from this and the analysis of legal relationships on which they are based may also be an important issue in relation with the debt adjustment procedure.[40] On arrears, all claims in the debt adjustment procedure will be classified as to the order of satisfaction depending on the *nature of the person making the claims and whether the specific claim is a preferential one.* Arrears such as wages and government revenues have higher priority than other suppliers. Claims for banks and bonds are considered equal to the claims of suppliers; the difference may be based only on how these claims are secured previously.

Priority of claims during debt adjustment. The assets must be divided among the creditors in the following way:

a. Regular wages and salaries, including severance
b. Claims secured with a lien, mortgage, or caution money up to the pledged value, provided that the security was stipulated at least six months prior to the commencement date of the debt settlement procedure
c. The state's claims arising from interest, payment, support provided for a compromise in bankruptcy concluded in the course of a previous debt settlement procedure, and the amounts of reimbursable targeted support and further reimbursable central budget support. (These are claims for grants, subsidies, transfers, and so forth that must be reimbursed for some reason by the municipality. This also includes repayment of the loan the state gives during a settlement

of a bankruptcy that happened before. So these are amounts owed by the municipality to the state)

d. Social security debts, taxes, and public debts that may be collected like taxes
e. Other claims (loans, bonds, and arrears to suppliers)
f. Interest, also default penalties and fees on claims listed under "d".

The claims of lower-priority-group creditors shall be settled after the claims of higher-priority-group creditors are fully settled. The amount available for settling the claims of creditors shall be divided among the creditors in proportion to their claims.

Municipally Owned Utilities and Corporations

How are services delivered? A municipality may render mandatory and optional services through a multitude of legal entities, such as (a) a budget agency of its own or that of another local government, including municipal associations; (b) a municipally owned enterprise that may be for profit or nonprofit; and (c) a private enterprise, including nonprofit enterprises and foundations, based on a service contract (typically concessions, PPPs). Local governments may participate only in business enterprises with limited liability. Thus, there are basically two types of municipal companies that are suitable for managing municipal assets or providing utility or other public services: a limited liability company (LLC) and a company limited by shares (Ltd).

Which insolvency act applies? The 1996 Municipal Debt Adjustment Law applies only to local governments, defined as (a) municipalities (both villages and cities), (b) Budapest (capital) and its districts, and (c) the local government of the counties (administrative units of the county). A budgetary agency or administrative unit of a municipality does not borrow on its own, and neither do municipal associations. In these cases, there is full recourse to the municipality as the legal entity engaged in borrowing. The insolvency cases of all business entities (limited companies or unlimited, any kind of business association) fall under the scope of Law XLIV of 1991 on Insolvency and Compulsory Liquidation, *regardless* of whether the actual company in question is owned partially or wholly by a subnational government or any other private shareholders.

Obligation to continue providing services. In contrast with corporate restructuring, municipal debt adjustment requires that certain municipal competences be carried out during the debt adjustment process. Among other things, utility services (water, solid waste, wastewater) shall also be rendered by the municipalities, even during bankruptcy of the municipality or an enterprise providing the services. The corporate bankruptcy act does not prescribe any kind of obligation for the liquidator to continue the business activity of the insolvent company. The obligation to provide, or to make arrangements to provide, services falls on the municipality, regardless of whether its own budgetary unit, its enterprise, or a private enterprise is actually contracted to do so. *Thus, a challenge emerges: the bankruptcy of a utility, regardless of ownership, falls under corporate law. But the service provision obligation that has been outsourced to this separate entity now falls back on the local government.*[41] The obligation to provide, or provide for, a service cannot be subordinated to any other municipal obligation. In other words, the potential bankruptcy of public service provision enterprises, such as water companies, hospitals, and district heating enterprises, does not entail financial recourse of creditors to the budget, but, rather, means *service delivery recourse* to the municipal budget.[42]

Other Issues

Assets created with EU Cohesion and Structural Funds, and cofunded with matching grants from the municipality and/or central government, face the contractual obligation of being in use for a minimum period of time. In other words, even nonessential assets that are funded with these EU monies must observe these "usage" rules, or else the grant recipient must refund 120 percent of the grant amount. In the case of a municipal insolvency, these assets may not change their use, let alone be a part of a debt settlement. If a municipality intentionally or mistakenly changes the use of an EU-funded asset subject to usage restrictions, then the national government, obliged to refund the EU, could place a lien on the municipality for 120 percent of the amount involved. The option to enforce or not enforce this kind of lien could be a source of a soft budget constraint and political bargaining, since the member state will refund the EU, and further steps are at its own option.

Subnational Insolvency Framework: Implementation Experience, 1996–2010

Database of Events[43]

There are 38 known formal cases of municipal debt adjustment in Hungary from 1996 to 2010 (table 7.2).[44] In the table, amount of debt means how much debt was recognized by the bankruptcy trustee and was actually a part of the voluntary settlement or forced liquidation. Of the 38 known cases, 30 have been settled. Of the 30 settled cases, 18 resulted in a voluntary workout agreements, and in 12 cases the court had to force liquidation of assets and debts. The cases' debt adjustment process reflects the distribution of municipal size and economic potential in that there were only 5 cases filed in municipalities with populations above 3,000, and only 2 cases filed in municipalities with populations above 5,000, that is, Szigetvár, with a population of over 11,000 and, recently, Esztergom, with a population of over 30,000.

Note that the categories in table 7.2 overlap, and that it is unclear in two cases what led to the debt adjustment filing. Viewed differently, 10 cases apply to excessively expensive and underused utility projects, mostly in the natural gas and wastewater sectors.[45]

Causes of Municipal Insolvency

Municipal insolvency cases often reflect several years of financial difficulties. Years before the filing, the municipality, its bank, and its suppliers attempted to work out informal arrangements to avoid the publicity and potentially unpredictable results of a formal debt adjustment procedure. By the early 2000s, it became known based on multiple liquidations that banks could expect to lose the entire interest claims, and on average up to 95 percent of its claimed unpaid principal in liquidation. Therefore, lenders were reluctant to file debt adjustment claims upon reaching the 60-day deadline. In addition, the creditors (all types, including suppliers) reportedly colluded to avoid a required municipal filing after 90 days. The State Audit Office has identified several hundred "latent" bankruptcies, where according to aggregate numbers and other indicators, the municipalities would have a legal obligation to file, but they do not, while lenders and suppliers tend to avoid filing, because it is not in their interest to involve all others who have claims against the debtor. "Latent" insolvency caused by systemic budgetary shortfalls,

Table 7.2 Municipal Debt Adjustment Filings, Hungary, 1996–2010

		Population	Debt (million forint)	Date of filing petition	Date of exiting bankruptcy	Reason	Result
1	Atkár	1,685	98	10/25/2001	8/1/2002	Debt from utility project	Workout agreement
2	Bakonszeg (I.)	1,278	152	8/22/1996	7/23/1998	Imprudent profit-seeking project, illegalities	Liquidation
3	Bakonszeg (II.)	1,278	60	8/3/2000	9/26/2001	New claim by creditors dissatisfied during first procedure	Liquidation
4	Bátorliget	783	79	8/22/1996	3/26/1997	Debt from utility project	Workout agreement
5	Biri	1,398	60	2/24/2009	12/10/2009	Mismanagement of school and public catering facilities	Workout agreement
6	Boba	822	40	1/16/2008	5/22/2008	Environmental fines due to incomplete sewerage project	Workout agreement
7	Csány	2,298	46	8/15/1996	4/3/1997	Debt from utility project	Workout agreement
8	Csepreg	3,333	89	4/15/1999	4/27/2000	Illegal VAT refund	Liquidation
9	Domaháza	1,082	22	11/20/1997	6/1998	Illegalities	Workout agreement
10	Dunafalva	1,185	69	3/13/2003	12/29/2005	Illegal public works contracts, arrears to suppliers	Liquidation
11	Esztergom	30,928	22,600	11/25/2010	In process	Divided government, political strife, unpaid invoices	In process
12	Egerszólát	1,107	24	8/25/1996	4/3/1997	Debt from utility project	Workout agreement
13	Felsőmocsolád	559	10	8/11/2005	8/3/2007	Miscalculation of operation and management costs	Liquidation
14	Forró	2,547	163	4/7/2005	12/15/2005	No information available	Workout agreement

(continued next page)

Table 7.2 (continued)

		Population	Debt (million forint)	Date of filing petition	Date of exiting bankruptcy	Reason	Result
15	Gilvánfa	341	26	9/21/2000	2003	Debt owed to utilities	Liquidation
16	Kács	654	32	12/12/1996	7/24/1997	Debt from utility project	Workout agreement
17	Jásztelek	1,775	10	12/2008	–	Labor rights lawsuit won by fired teacher; court ordered compensation payment caused insolvency	Unknown
18	Kajászó	986	85	4/3/2008	12/22/2008	Excessive investment in new and upgaraded health, cultural, burial, sports facilities	Workout agreement
19	Magyardombegyház	259		9/9/2010	In process	Excessive pay for mayor; kindergarten with only 10 children	In process
20	Nágocs (I.)	856	123	9/5/1996	7/23/1998	Criminal and imprudent business activities	Workout agreement
21	Nágocs (II.)	856	46	9/21/2000	5/9/2002	Unmet claims resubmitted	Liquidation
22	Nemesgulács	1,100	118	6/21/2007	1/28/2008	Disputed final payment to contractor	Workout agreement
23	Nemesvid	830	750	6/15/2010	In process	Sw F debt from sewerage system project, Sw F currency rate rising	In process
24	Neszmély	1,444	140	7/23/2008	11/11/2009	Environmental fines for illegal waste dump; illegal guarantee offered to municipal nonprofit enterprises for their borrowing	Liquidation
25	Nick	563	91	11/22/2007	In process	Illegal VAT refund	In process
26	Ópályi	2,983	64	11/7/2008	7/17/2009	Excessive operational expenses related to elementary school and its refurbishment	Workout agreement

27	Páty	4,998	400	8/15/1996	3/4/1999	Debt from utility project	Liquidation
28	Pilisjászfalu	993	300	1/7/2008	11/18/2008	Succession from larger community; inability to finance any basic functions	Workout agreement
29	Ráckeresztúr	3,300	1,000	3/2010	–	VAT fraud, vendor loans, criminal investigations, Audit Office investigaton, countersuits in play	Under appeal
30	Sáta	1,391	55	2/25/1999	8/1/2002	Debt from utility project	Liquidation
31	Sáta (II.)	1,391	90	4/14/2010	In process	Unpaid invoices due to loss of school funding/unwilling to consolidate with neighboring villages	In process
32	Somogyfajsz	553	86	7/29/1999	9/13/2001	Criminal activity	Liquidation
33	Somogyudvarhely	1,208	31	3/5/1998	11/19/1998	Debt from utility project	Workout agreement
34	Somosköújfalu	2,234		10/6/2010	In process	Utility construction	In process
35	Sorokpolány	825	11	4/1/1999	12/30/1999	Illegal VAT refund	Workout agreement
36	Sóstófalva	3,509	6	1/21/1999	12/30/1999	Default on loan to remodel community center	Workout agreement
37	Szigetvár	11,353	3,500	2/26/2010	10/29/2010	Complex reasons, overinvestment, lack of funds for operations, faulty planning, PPP projects	Workout agreement
38	Tiszaderzs	1,357	71	1/7/2008	In process	Default on loans to build local roads and sports arena; mayor under criminal investigation	Liquidation process started

Source: Author.

Note: There are five more cases with the date of filing and the date of process ending indicated in parantheses: Kisnamény (1/8/2009, 1/4/2010), Nagydobos (12/9/2010, 9/6/2011), Selyeb (10/12/2009, 10/14/2010), Ősi (12/28/2010, in process), and Tiszavalk (3/25/2009, 2/5/2010). Sw F = Swiss franc, VAT = value-added tax, – = not available.

illustrated by the large number of deficit grant applicants, reflects structural fiscal deterioration.[46] It is difficult to enforce the sanction (Article 5 of the Municipal Debt Adjustment Law), given the current state of accounting and budgeting practices.

The compliance and enforcement aspects of the Municipal Debt Adjustment Law have been its weakest links. The cash-based accounting system makes it difficult to detect insolvency and impose sanctions on an involuntary basis. Based on the State Audit Office report (Vigvári 2009), the rollover of payment arrears, hidden and explicit short-term borrowing, and contingent liabilities suggest a multitude of latent defaults that are never uncovered, nor do they trigger events as per the Municipal Debt Adjustment Law. There is little consequence for ignoring the mandatory filing threshold.[47]

Table 7.3 summarizes the causes of municipal insolvency for these formally filed cases. These cases represent different origins of financial problems. The three "older cases" during the five years since the 1996 Municipal Debt Adjustment Law reflect different causes of financial problems: inappropriate and unauthorized borrowing, VAT disputes, and imprudent utility projects and guarantees given by municipalities to private ventures. About 61 percent of cases are project-related fiscal

Table 7.3 Main Causes of Bankruptcy in Hungary

Cause of financial distress in filing documents	Number of filings (of 38)
External hits	
VAT refund clawed back by tax office	4
Environmental fines	2
Criminal cases	
Illegal and criminal activities, fraudulent contracts	3
Project related	
Overinvestment, imprudent borrowing, miscalculated operating expenses and revenue	16
General liquidity and management	
Procedural causes, contract disputes, labor problems, political strife, and so on.	5
Arrears in operational expenses (schools, etc.), structural	6

Source: Based on table 7.2.
Note: Two cases have unknown causes. VAT = value-added tax.

risks including overinvestment, ill-planned borrowing, miscalculated operating expenses and revenues, and arrears and contingent liabilities. External shocks such as environmental fines and taxation disagreements with the central government account for 17 percent. Management-related issues such as labor and contract issues account for 14 percent.

Four more recent cases reinforce the general conclusions drawn from cases and highlight additional elements that lead to debt adjustment.[48] The *environmental fine* applied in the case of Boba was massive, equaling 25 percent of the village's annual budget; the Environmental Inspectorate did not apply similar fines to many other villages in Boba's region. *Ráckeresztúr* added a new element in that a vendor attempted to exercise its rights under the Municipal Debt Adjustment Law but was foiled through an appeals process for two years. This is the first example of a vendor attempting to exercise its options but having to wait until the village was forced to declare bankruptcy for other reasons.

Tiszaderzs is an example of new borrowing from a secondary financial institution once the village's primary bank refused further loans. The village also overcommitted itself in a sports facility project that was built using a PPP scheme subsidized by the state-owned development bank. The anticipated cash flow for debt service based on the planned student enrollment did not materialize, because students were later consolidated with another village under the government incentive for consolidation. Tiszaderzs' experience indicates that the budget forecast for debt service can be impacted by central government fiscal incentives designed for different objectives.

Finally, *Szigetvár* is the largest city so far to undergo bankruptcy in Hungary. In this case, there was an interrelated web of guarantees provided by the city for its hospital, PPP contracts with its own water company, and direct borrowing by the city that was beyond its ability to pay, combined with political events that worked to the disadvantage of the city.

Lessons Learned and Strengthening the Legal Framework

The legal procedure in the bankruptcy law is transparent and explicit. Each step is described in detail so that each participant knows what comes next and what his or her responsibility is. There were no disputes concerning procedures in any of the cases. The bankruptcy trustee (receiver) and court have authority and are respected. The quality and performance of the county courts and judges have not been a problem.[49]

No moral hazard. The law has clearly established that the state will not guarantee the debt of a municipality (unless through an act of Parliament and after a fee has been paid to the National Bank at the request of a multilateral lender), nor does the state assume responsibility for a municipality's borrowing after it has defaulted. Commercial guarantees are available in the market from financial institutions, and from a guarantee company operating under the commercial code that is co-owned by the state and all commercial banks.[50]

The local assemblies cooperated with the court and the trustee in each bankruptcy procedure. No assembly was threatened with new elections or dissolution. One source of difficulty was that some municipal assemblies hoped that the bankruptcy trustee would provide them with ideas for financial and organizational reforms, and also make difficult decisions on their behalf. The trustees can only suggest the details of viable reorganization plans and supervise the negotiation of workout agreements. If the parties involved could not or did not want to agree, then the trustees have legal power to suggest workout and liquidation plans to the court, which does impose settlements in about 40 percent of the cases.

Vital public services were maintained in each case. Successful reorganization plans came about with the full involvement of the assembly and the management of municipal institutions. In these cases the trustee simply reviewed the suggestions made by the reorganization committee. In all of the cases known to date, vital services were maintained, which is one of the purposes of the Municipal Debt Adjustment Law.

The debt adjustment procedures gave participating municipalities a clean slate to move forward, enabling them, in theory, to continue to borrow for development purposes. But some municipalities that have undergone debt adjustment may continue to operate in difficult economic conditions, and are likely to remain uncreditworthy for reasons other than an earlier debt adjustment. Furthermore, external events such as tax disputes could put pressure on municipal finance, triggering insolvency procedures.

In a significant portion of the cases, insolvency was due to accounting and internal regulatory shortfalls. In these cases, there were no countersignatures, no internal controls, receipts were missing, and assembly decisions were a result of incomplete or misleading information. Nor did the local assembly decisions address all of the issues related to borrowing.[51] As a consequence, unpaid bills accumulated, if they were recorded at all.

Informal preemptive arrangements head off formal filings. There has been a relatively low number of formal debt adjustments. Although a municipality may not file for bankruptcy, creditors and debtors often negotiate in the shadow of the law. From a bank regulatory perspective, this may be a problem if insolvency becomes more frequent, because nonperforming assets such as loans to municipalities and bonds in default must be accounted for under Basel II,[52] with additional reserves set aside. Transparency can be compromised if a municipality is in default but keeps the information from bank shareholders, regulators, and the public. From the perspective of suppliers and vendors, municipalities tend ultimately to pay their bills, although often after the payment deadline. Vendors often include a "late fee" to price in the risks of arrears and nonpayment.

Lenders, suppliers, and other vendors have little incentive to initiate a bankruptcy proceeding (which is their right),[53] since they stand to lose a significant portion of their claim unless they are directly involved in operating a mandatory service. The Municipal Debt Adjustment Law was implemented only when basic municipal functions were endangered by a lien on funds, court-ordered collection, or the execution of a judgment against the municipality (e.g., an environmental fine or a labor lawsuit) used as a last resort. Those vendors and suppliers that provide mandatory services will continue to be paid during an adjustment procedure and to enjoy priority in the emergency budget. Lenders, however, often fund nonmandatory services and have individual claims that are larger than the individual claims of a group of vendors.[54] Since all debt (including debt still under a grace period) becomes due in a debt adjustment procedure, the creditor side has a great incentive to make a deal in private, to the potential detriment of others.

Once debt adjustment negotiations start, the larger creditors stand to lose the most, since proportional reductions are nominally larger, and penalty interest and late fees are assessed in full, while suppliers have limited ability to add such charges, and they seem to be the ones that hold out, bringing the liquidation process upon all the rest, and in the end, all creditors take a hit. Larger creditors such as banks tend to argue intensely for full payment of interest, interest penalties, and capital, knowing that their claim alone exceeds funds available to all other classes of creditors. But the tendency is for these large creditors to insist on their claims at the risk of moving into a court-ordered liquidation, which in relative terms will hurt them the most.[55]

In most cases under debt adjustment, municipalities were already late in payments to creditors and vendors for several years, but it was the significant operational deficits during the period immediately before a bankruptcy that led to the filing by municipalities. Thus, in the months before insolvency, the amount of unpaid bills for operational expenses could substantially increase. In these situations, the municipalities could not even stay current on their invoices for operational expenses. The suppliers' patience eventually runs out, and court-ordered payment liens arrive, forcing the municipality to ask for bankruptcy protection. Creditors may wait four to five years before taking action, and then endure protracted lawsuits and appeals, when they could simply exercise their rights 60 days after a valid invoice becomes due. Yet, they do not use their powers granted in the Municipal Debt Adjustment Law, based on the fear that in an adjustment scenario, all claims will be reduced, especially if they pertain to "nonessential" services. No business wants to be seen as being tough on municipalities, because that could generate bad publicity in a competitive business environment.

There are no credit bureaus, public sources of budget data, or early warning systems. A potential supplier or lender to a municipality has no access to a public database of payment histories. The bank that handles the transaction account has a significant advantage in knowing the financial management skills and payment discipline of its client. The account management bank is hence more willing to extend overdraft loans and renegotiate long-term loans, since it has the power to seize funds from the municipal account directly. The rest of the banks and all of the vendors and suppliers lack this security mechanism and instead rely on "relationship" banking.

Recent Changes in the Legal Framework

Except for adding the provision for the possibility of appeals to the law in 2001, the Municipal Debt Adjustment Law itself has not been amended since it came into force in 1996. Recently, decrees announcing decisions by judges regarding bankruptcy procedures have been published electronically, so the time to reconsider and perhaps withdraw a petition has been drastically reduced to a few days.

Two changes in legislation (in 2008 and 2010) would impact the municipal fiscal accounts. The first change is the Act on the Status of Budget Subjects (Law CV, 2008). This law states that municipal enterprises operating under the Enterprise Law that receive more than two-thirds of their revenue from the municipal budget in any form (subsidies, contracts) must be dissolved and their functions transferred to an existing or new budget agency. If a municipal enterprise performs a mandatory service delivery function but is financially dependent on municipal support, the 2008 law will make transparent the contingent liabilities of the enterprises to the municipal budget. The off-budget entities that are financially self-reliant are not likely to be compelled to perform mandatory municipal functions. Revenues from water fees collected by a municipal water enterprise, for example, may flow directly into a budget agency, and the municipal water enterprise cannot use the water fees for other nonmandatory, often profit-seeking activities. But the apparent mixing of mandatory and optional functions in a municipal enterprise[56] may make it difficult to show that two-thirds of revenues come from the budget, because those flows will be diluted with other enterprise revenues.

The second change was in 2010 with the enactment of a new Treasury rule that intends to reduce the potential negative impact of the central government decisions (with respect to funds allocated to the local governments) on local government finance. The change could be in direct reaction to the five bankruptcy cases. In these cases, the municipal finance deteriorated after the central government seized VAT refunds, overpaid grants, and other revenues, or after the central government imposed fines (such as in the case of Boba). According to the 2010 change in treasury rules, when the Treasury places a lien on or intercepts a municipal fund, it could allow installment payments by the municipality to avoid "adversely affecting" the performance of mandatory tasks.[57]

Strengthening the Insolvency Framework

Consensus is emerging among stakeholders (such as representatives of the central government, lenders, and service providers to municipalities) on the need for strengthening monitoring, audit, oversight, disclosure, accounting standards, and budget procedures for municipal governments. This section summarizes a common set of observations derived from discussions in Hungary on potential reforms to strengthen the municipal insolvency system.

There are several hundred latent cases of insolvency among municipalities, but these are not formalized into bankruptcy cases, due to a shared interest among lenders, municipalities, and their suppliers to settle matters informally and out of public view. In all documented cases of debt adjustment, the debtor and some of the creditors engaged in informal negotiations, to reschedule debt or to gain access to new forms of security. This kind of pre-adjustment negotiation essentially is expanded during the first formal phases of bankruptcy, when the emergency budget and workout agreement are negotiated, and the trustee prepares an examination of the finances of the municipality.

Bilateral negotiations are an integral part of all insolvency regimes (and are substantial instruments in corporate insolvency cases, as well). The priorities as prescribed by insolvency laws provide the backstop for voluntary restructuring negotiations, shaping the bargaining power of creditors and debtor even outside bankruptcy (Liu and Waibel 2008). However, a lack of transparency may benefit one class of creditors at the expense of other classes. A pre-bankruptcy negotiated restructuring will need to be made transparent, with fair access to information by all affected stakeholders. Information transparency helps the public to access municipal financial and budget data. In the United States, the voiding of preferred arrangements and recovery of preferred payments, coupled with transparency, public access, and "sunshine," have substantially reduced the problem of nontransparent prefiling negotiations (De Angelis and Tian forthcoming).

The bankruptcy proceeding will need to clarify the treatment of the PPP contracts: Are they debt? Do they provide mandatory services? And what happens if they provide blended services? PPP payments are treated as service contracts. Under a debt adjustment scenario, a type of service must be classified as either mandatory or nonmandatory. If part of the service provided by a PPP is classified as nonmandatory, then part of the fee relating to the "nonmandatory" portion may be withheld from payments. This may cause further insolvency for the PPP provider as the legal entity.[58] Cutting off nonmandatory payments to an operator that also conducts mandatory operations may impact the financial health of the operator. International experience shows that PPP contracts are complex and their treatment as debt or long-term service contracts needs to be clarified in budgeting, accounting, debt limitation, and debt adjustment legislation (Irwin 2007). Long-term PPP contracts affect not only the sharing of risks, including performance risk over the long run, but funds paid to PPP contractors impinge upon cash available for other expenditure items, including debt service.

Another reform relates to the ex-ante regulation of borrowing in the Municipal Act, in force until 2012. Restrictions on the use of long-term borrowing to cover operational deficits (such as requiring short-term loans to be cleared perhaps 30 days in advance of the end of the budget year) would help prevent the rolling over of overdraft and short-term loans into the next budget year. Better management of refinancing risks such as currency risks would help municipalities improve their debt portfolio. The risks of guarantees would need to be accounted in the borrowing rules; cross-country experiences offer valuable references.

Reforms in intergovernmental fiscal systems and other areas complement the debt restructuring framework. The insolvency law alone cannot address the root causes of fiscal imbalance. Basic mandatory functions are underfinanced for many municipalities, with an average level of financing deficit ranging from 30 to 40 percent. Strengthening municipal own revenues will help improve their creditworthiness. Reform of the budgeting and reporting system is also needed; the current reporting formats are difficult to use and often miss critical information. Better recording, release, and monitoring of financial information could help prevent the accumulation of arrears and operating deficits. An early warning system via better reporting would be beneficial. A reform change that went into effect in 2011 requires a municipality considering borrowing or issuing a bond to conduct an independent audit, the results of which must be disclosed to all concerned parties and the public.

An important budgetary reform has taken place—*the separation of operational and capital budgets.* Starting with the 2010 budget, the State Budget Act requires the separate listing of operational and capital revenues and expenditures, showing the balance in each account. Deficits and the sources of financing both capital and operational deficits would have to be shown explicitly: from cash accumulations, long-term borrowing, or an operational surplus. This is a major improvement in budget presentation. Properly implemented, it could reduce risk through better information. It has been too easy to hide operational deficits by simply showing a planned asset sale that covers the planned deficit, bringing the budget plan into balance.

A more drastic improvement would involve *the calculation of operational and capital balances* separately, and limiting current and future debt service by a coverage ratio. This would involve significant changes to the budget and accounting structure, but in the long run is a more predictive measure than a simple debt service ratio that allows debt service even if there is an operational deficit. A final step would be to add an element of time, that is, to require the stock and flow limits to be estimated into the future, taking projected revenues and debt payments into account on a multiyear basis.

Conclusions

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

Hungary's Municipal Debt Adjustment Law, enacted in 1996, works to reduce the uncertainty faced by creditors and debtors in the case of municipal default on loans or vendor payments. The implementation experience has exceeded the original expectations of the framers of the law. There have been few complaints against the law, the courts, the trustees, or the implementation process. The legal procedure per the law is transparent and explicit. The moral hazard of bailouts has been minimized, essential services have been maintained, and local assemblies have cooperated with the court and the trustee in each bankruptcy procedure. The debt adjustment procedures have given participating municipalities a clean slate to move forward.

Its main implementation challenge—noncompliance—cannot be directly attributed to the legislation itself. Many of the cases reviewed here have debt and vendor payments that are over 90 days late, when the law requires a filing to take place. Filings do not take place for many reasons, including the lack of monitoring and sanctions, and informal rescheduling and negotiations that could negatively affect the interests of less-informed or smaller creditors.

Consensus is emerging among stakeholders on the direction of strengthening the municipal insolvency system. There is a need to make the pre-bankruptcy negotiated restructuring more transparent so that the pre-negotiations are fairly and transparently conducted among all creditors and the municipal debtor. An early warning fiscal monitoring system would help prevent the accumulation of operating deficits, arrears, and contingent liabilities. The treatment of PPP contracts would have implications for the performance of mandatory and nonmandatory functions. Reforms in the municipal budget, accounting, reporting, disclosure, and oversight systems will complement the insolvency law. The Municipal Debt Adjustment Law works, but it cannot be used to correct the structural challenges in Hungary's local government system.

Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

1. Inspired in part by the U.S. experience with Chapter 9 municipal bankruptcy and with various forms of financial control and reorganization boards, Hungary's law was written with significant input from U.S.-based consultants

supported by the U.S. Agency for International Development and private foundations.

2. See the 1991 Law on Bankruptcy and Liquidation (Law XLIX), revised version, in force since March 2012.
3. The bankruptcy of municipally owned enterprises such as water utilities or public transport companies falls under corporate bankruptcy rules. The obligation to deliver such services is always municipal. If the firm providing such services is wound up (i.e., forced to close), the service obligation, and all assets and liabilities associated with it, are passed on to the legal successor, most likely a municipal department. Assets and liabilities not directly affiliated with the mandatory public service remain part of the corporate bankruptcy. Contracting out of mandatory services in any form (PPPs, concessions, and so forth) does not absolve the municipality of its obligation to deliver a list of mandatory services that are defined specifically in several pieces of legislation.
4. These cases occurred after the last major study, which was made by Jókay et al. (2004), and Jókay, Szepesi, and Szmetana (2004).
5. The National Bank of Hungary reports on the financial accounts of the public sector on a quarterly basis. Municipal financial assets, such as cash and deposits, are reported along with ownership shares in municipal companies at face value, and these shares are not revalued in line with changes in total balance sheets or owners' equity.
6. Communist-era managers were able to purchase state assets at fire-sale prices, then sold the assets to foreign investors.
7. See Kopányi et al. 2004, 15–75.
8. During 1994–95, when the Municipal Debt Adjustment Law was being designed, a working group that included bankers tried to lobby against the act, since the bankers believed they were doing the public a service by making risky loans that, upon default, should naturally be paid by the central government.
9. The existence of the Debt Adjustment Law reduced the uncertainty that troubled banks in the early part of the 1990s: what happens if there is a default? A clear answer was given: the risk of making imprudent loans would have to be borne by the lender. This notwithstanding, imprudent loans were made in many cases that led to debt adjustment during 1996–2010, but fear of the debt adjustment process did, as many bankers indicated informally, restrain them from making too many marketing-based loans that were too risky.
10. Government Decision 1092/1995 (IX.28) transferred funds to cover a portion of the expenses of municipalities in distress due to their own fault. These communities included Bakonszeg, Bátorliget, Nágocs, Páty, and Szerencs, all of which (except Szerencs) eventually underwent a debt adjustment process.
11. See http://conventions.coe.int/Treaty/en/Treaties/html/122.htm.
12. Counties, the middle tier, do not have these rights, and regions, a creation for the sole purpose of gathering statistics for EU projects and planning, have none

of these characteristics and are not recognized in the Constitution). At the end of 2011, there were 3,196 municipalities in Hungary: Budapest capital, 23 districts of the capital city, 19 counties, 23 towns with a county status, 304 towns (cities), 120 villages, and 2,706 parishes (small towns).

13. Starting in 2013, education and many other human services will be centralized, signalling a significant drop in the share of GDP accounted for by municipal spending.
14. The Municipal Debt Adjustment Law defined the tasks of municipalities. This part of the law has changed more than once since, with some tasks removed and others added.
15. Data for the share of each type of revenue in total municipal revenue are from the "Annual Budget Report" of the Ministry of Finance.
16. Data are for 2008. *Source:* "Annual Budget Report," 2008, Ministry of Finance.
17. Data for this and the following two paragraphs come from the National Bank of Hungary, annual budget reports of the Ministry of National Economy (previously Finance), the State Debt Management Agency, Eurostat, the International Monetary Fund's Fiscal Outlook, and Article IV reports on Hungary.
18. Hungary's public-debt-to-GDP ratio increased from 67 percent in 2007 to 81.4 percent in 2010, with a significant portion of the increase from a rapid devaluation of the forint compared to the euro and the Swiss franc.
19. Between 2007 and 2011, the forint dropped by 66 percent against the Swiss franc, by 23 percent against the euro, and by 40 percent against the dollar.
20. Hungary's prime rate was 7.5 percent in 2007, peaked at 11.5 percent in October 2008, was lowered to 5.75 percent in 2010, and was 7 percent in June 2012. The 10-year bond rate vacillated between 7.08 and 9.75 percent, ending 2011 at 8.48 percent.
21. At prevailing year-end exchange rates.
22. Based entirely on National Bank of Hungary financial accounts statistics; http://www.mnb.hu.
23. For 2013, these transfers are to be cut by 40 percent to reflect the centralization of most municipal functions to central state organizations.
24. This is different from the usual 15 percent of total revenues debt service formula used in the region.
25. Private placement criteria in Hungary are derived from the 2004 EU Markets in Financial Investments Directive (MiFid). This means that no permit for bond placement is needed from the securities regulator, and only qualified investors may purchase bonds (to a numerical limit of 100 qualified investors). The face value of each bond should be no less than 50,000 euros. The offering statement must be filed with the regulator. Regulation prior to accession in 2004 restricted private placements to 50 "professional" investors. There are no specific municipal disclosure standards except for public offerings.
26. They may change banks for this primary account once a year, reporting the change by October 31. Thus, September and October are intensive bank lobbying

months, when financial institutions work hard to land accounts currently managed by their competitors.

27. Author's estimates based on reports from the Treasury and press accounts.
28. Based on the debt stock figures from the National Bank of Hungary.
29. See, for example, Vigvári 2009.
30. These reasons were common in professsional discourse, but were summarized in the National Bank Review (September 2008), as cited at http://www.mnb.hu/Root/Dokumentumtar/MNB/Kiadvanyok/mnbhu_mnbszemle/mnbhu_szemle_cikkek/homolya_daniel_szigel_gabor.pdf.
31. One small village, Nemesvid, faced serious currency risks.
32. See National Bank Review, September 2008 cited in footnote 30.
33. Guarantees are provided only if required by the lender, such as by the international financial institutions, but the National Bank charges a guarantee fee, and sovereign guarantees of municipal borrowing in such multilateral frameworks are rare. In onlending situations, the onlending institution, a domestic bank, lends at its own risk, and has no recourse to the sovereign, even if the funds originally enjoy a sovereign guarantee in favor of the original source of funds.
34. In Hungary, County Courts are the court of first instance for most civil and criminal cases, except for courts in the larger cities, such as the Budapest City Court. Judges are assigned based on their experience and qualifications. Corporate bankruptcy and liquidation began before the system change in Hungary in the late 1980s. By the time the Municipal Debt Adjustment Law was passed, county judges amassed both bankruptcy and public administration experience. There has been no documented or reported failure on the part of any court to follow procedures or to adjudicate liquidations (where necessary) at the request of the trustee. Apart from the usual capacity and infrastructure problems, these courts have performed well. Since the inception of electronic publishing of decisions, the initial steps in a debt adjustment filing have been reduced to 48–60 hours, as seen in the case of Szigetvar.
35. See the complete English translation of the Municipal Debt Adjustment Law for a more detailed description of the procedure (see Jókay 2012).
36. Article 5 of the law states that the court may impose fines of 100,000 forint (about US$500) on the mayor or a person acting on his or her behalf for violations of any section of the law. Not filing for debt adjustment after 90 days or not cooperating with the crisis budget committee, the court, or the trustee could lead to multiple penalties.
37. The trustees are selected through an open competition held every five years (the latest occurred in 2009). The Interior Ministry requires that those who apply already be certified corporate liquidators, or represent firms with at least three years of liquidation experience. In addition, trustees need to have at least two years of municipal finance or budgeting experience and to have liability insurance of at least US$150,000. For this reason, only 23 firms qualified based on their experience as firms, not individuals. These rules are laid

out in Government Decree 95/1996. The latest list of firms eligible for appointment was published in the Interior Ministry's Gazette on July 16, 2009.

38. The receiver shall forward the invitation complete with its attachments to the creditors at least eight days prior to the meeting. Depending on the number of creditors, creditors may be invited in separate groups to negotiate a compromise in bankruptcy.
39. The law was modified in 2001 to include more possibilities for appeals. As a result, several cases have taken much longer than envisioned in the original law. Forced liquidations have taken place in these cases, since there was no incentive to reach an agreement, and assets available to cover debts were insufficient. An impasse could only be overcome by an agreement imposed by a judge.
40. Municipal finance procurement advisor Dr. Gábor Szepesi has indicated that about 80 percent of bond issues are not secured by any collateral at all, since interest rates (10–20 basis points above the benchmark) and grace periods (four to five years on a 20-year bond) became so competitive that arrangers had to agree to no collateral investing to stay attractive in competitive negotiations.
41. There are examples of the opposite. A district heating plant operated by a chemical factory that went bankrupt also served a residential area with hot water and heat. The company operating the heating plant was liquidated, and since district heating is not a mandatory function, many households went without service. The municipality of Fuzfo tried to take control of the heating assets, but the liquidators were not obliged to hand them over and did not (based on author's field interview).
42. If an enterprise has majority municipal ownership, defined as more than a 50 percent share, and it is performing public service functions, special mandatory liquidation rules apply, according to the Act on the Status of Budget Subjects (Law CV, 2008). This means that if a majority-owned municipal enterprise that is carrying out municipal functions becomes insolvent and is subject to corporate bankruptcy, the founding public entity is fully responsible for providing uninterrupted and consistent service (water, solid waste, wastewater, public sanitation, and so forth) instead of the bankrupt enterprise. The cost of providing a service will be paid for from the municipal budget), and those assets, liabilities, and contractual obligations that are related to that mandatory service pass directly from the bankrupt entity to the owner, that is, the municipality.
43. This database was assembled using paper and electronic court records and press reports, since no central listing of bankruptcies of municipalities is available from the government or private credit bureaus. Only Budapest is rated by several agencies, so this constitutes original research by Laszlo Osvath and Charles Jókay using previous data until 2004, then new data since then.
44. There may be incomplete information on some, where the exact date and text of the court decrees were not available. This study examined Szigetvár in detail,

including field interviews with all stakeholders, and examined the 5 new cases using desk research and interviews when appropriate. The rest of the database, or the first 28 to 30 cases, was examined in detail by previous studies (Jókay and Szepesi 2003; Jókay et al. 2004; Jókay, Szepesi, and Szmetana 2004; Jókay and Veres-Bocskay 2009), but there is no extensive literature on municipal bankruptcy or the Municipal Debt Adjustment Law itself. The electronic database of newspaper and court documents extends back to about 2000; earlier materials exist only in paper form. Almost all of the material used to describe the cases and to formulate generalizations is available only in Hungarian. The general observations and lessons apply to a composite of the cases known to date. Boba, Ráckeresztúr, Szigetvár, and Tiszaderzs produce many of the same conclusions; however, each new case introduced elements that were not that relevant earlier.

45. Several newer cases that are not described in detail in this study nevertheless deserve to be briefly mentioned. Sáta, a village of 1,400, is repeating a debt adjustment procedure eight years after having ended the previous one with forced liquidation. The newer case was caused by a deeply divided council that refused to consolidate the village's primary school with that of a neighbor. Persistent unpaid bills in the school budget led the mayor to file for debt adjustment to show their inability to finance their school under the current fiscal system. Neszmély, a village of wineries on the Danube, turned to debt adjustment when it could not pay a large environmental fine, and even tried to convince a local business to lend it money in lieu of paying the local business tax. The village management turned to unauthorized borrowing, while the initial problem was compounded by another extension of an environmental penalty. Biri, a village of 1,200, amassed 17 million forint in unpaid utility bills related to its school out of a total budget of 190 million forint. The unpaid bills eventually totaled 50 million forint in unpaid current obligations. Felsőmocsolád, a village of 600, decided to build a sports facility but failed to complete it. It did not qualify for the deficit grant since its problem was caused by an overextended investment. Its annual budget was 270 million forint, and the sports facility cost 170 million forint. Although it claims that not getting the deficit grant is the reason for the bankruptcy, in reality, the sports facility was oversized, and the operations and maintenance expenses of the unfinished facility could not be covered by its budget. (These cases are based on field interviews and press reports).
46. Vigvari (2009) introduced the concept of latent bankruptcies.
47. The amended Municipal Debt Adjustment Law in 2011 relieves mayors of the obligation to file for insolvency upon reaching certain thresholds. A mayor may only petition the court if the local assembly has approved the filing.
48. For a detailed analysis of the select cases, see Annex 2 to Jókay (2012).
49. When the Municipal Debt Adjustment Law was being designed in 1994–95, there were concerns about whether corporate bankruptcy experts would be competent to serve in municipal situations. This concern was overcome by implementation experience. The chief judge assigns cases to the bankruptcy

trustees based on experience or qualifications. Trustees must be on a list of qualified firms with reorganization and liquidation skills in the corporate sector. In addition, the firms must demonstrate competence in public sector finance, accounting, and municipal governance. Twenty-three firms were recertified by the Ministry of Finance in 2009. There is no evidence that the county courts and their judges have faced difficulties adjudicating and supervising these cases. The county judges assigned to these 38 cases already had 20 years of corporate bankruptcy experience or experience in the general court system handling civil, criminal, and administrative cases. There are no specialized bankruptcy courts or public administration courts in Hungary.

50. Garantiqa Plc (see http://garantiqa.hu/en/local-governments) reported a perfect payment history on its 140 guaranteed municipal bonds and loans. This is due to active management of their clients, constant monitoring, and a product that "buffers" the debtor from the lender in a "pre-insolvency" period that is backed by the guarantee. By the time the lender is not paid, the problem has been solved by the guarantee company.
51. In one case, the mayor exceeded his legal authority in signing contracts and in making verbal commitments to vendors that were not documented.
52. Hungarian banks, like all banks domiciled in the EU, are subject to the Basel II Revised International Capital Framework on prudency, reserves, and capital requirements (see http://www.bis.org/publ/bcbsca.htm).
53. With two exceptions, creditors and suppliers did not initiate debt adjustment procedures against a municipality.
54. The low recovery rate is also explained by a combination of factors including overestimation by lenders of cash flow and proper collateral, financial shocks caused by regulatory and tax events, or fiscal mismanagement by borrowers. The rapid depreciation of Hungarian currency also contributed to the difficulty of making debt service payments on foreign debt (see discussion on the impact of the global financial crisis in "Structure of Subnational Governments and Their Finance" section). Assets available as collateral are used to cover the claims of all creditors in an insolvency case. Book value, market value and potential liquidation value at distress sales are often a part. Experience suggests that banks do not make a windfall by gaining access to book-value land; their overall claims are not being met in full.
55. Based on previous research by the author (Jókay, Szepesi, and Szmetana 2000, 2004).
56. As in the case of the Szigetvar water utility.
57. The Treasury has the authority to extend the one-year installment option to three years. But the law does not invalidate the 60- and 90-day trigger events in the Municipal Debt Adjustment Law.
58. In the case of Szigetvar, for example, the water company providing a mandatory service is also the PPP contractor. Withholding PPP payments for operating an instructional pool may endanger the built-in cross-subsidies the water company needs to survive.

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8

United States: Chapter 9 Municipal Bankruptcy—Utilization, Avoidance, and Impact

Michael De Angelis and
Xiaowei Tian

Introduction

As a result of the global trend of decentralization and increased subnational[1] fiscal autonomy, the restructuring and discharge of subnational debt has emerged as a critical issue. Due to the 2008–09 economic crisis and the declining fiscal conditions facing U.S. municipalities,[2] and to certain municipal financial practices related to funding of pension obligations,[3] municipal bankruptcy has become a relevant and much discussed issue in the arena of municipal finance. The importance of the issues and the risks associated with municipal insolvency are increasingly recognized.[4]

In the United States, Chapter 9 of the U.S. Bankruptcy Code[5] for municipalities[6] has long been established although rarely used. However, past experience may not be an accurate predictor of the future.[7] Observers speculate that future Chapter 9 filings may be driven by municipal pension and health care liabilities. Press accounts indicate that these liabilities may reach crisis levels for many municipalities.[8] During the past two years, there been considerable media attention and market concern about the prospect of municipalities filing for protection under the provisions of Chapter 9 of the U.S. Bankruptcy Code.[9]

The increased interest in Chapter 9 and its recent use or consideration in several high-profile cases has resurrected interest in its provisions.[10] This chapter assesses the current state of Chapter 9 municipal bankruptcy and its use and impact on municipalities facing severe fiscal distress.

Prior to the enactment of Chapter 9 in 1937, the only remedies available to creditors when a municipality was unable to pay the creditors were for the creditors to pursue an action of mandamus[11] and compel the municipality to raise taxes or to seize its accounts. The general rule is that "public property" dedicated to a public use is not subject to debt foreclosure. In practice, very little property falls into the "proprietary" category. This argument may also apply to funds in the public treasury accounts to be applied to public purposes.[12] These remedies were largely ineffective and, in particular, created an environment that induced individual creditors to *race to the courthouse* to file separate mandamus suits. Creditors that might be disposed to negotiate a settlement were dissuaded if any creditor refused to agree to a settlement and *held out* for full payment, called the *holdout problem*. During the Great Depression, these remedies proved ineffective.

The fundamental objective underlying the enactment of Chapter 9 is to provide a distressed municipality court protection from creditors, while it develops and negotiates a plan for adjusting its debts in a manner that enables it to continue to provide essential services.[13] A municipality, unlike a private corporation, is not created to generate profits but to provide public services to its residents, and it has an obligation to continue to provide these services even when facing economic difficulties.

Approximately 600 municipal bankruptcy petitions have been filed through 2011.[14] Most of these filings were by small, special-purpose districts such as water and sewer districts or small rural municipalities.[15] There were only 252 municipal bankruptcy filings between 1980 and 2011.[16] This compares to 51,259 business filings under Chapters 7 and 11 in 2010 alone.[17] A Chapter 9 filing for municipal bankruptcy by a general purpose municipality is a relatively rare event.[18] Default on debt appears to be equally rare. A study by Moody's Investors Services found that only three general purpose governments rated by Moody's had defaulted on long-term bonds in 30 years.[19,20]

Municipal bankruptcies are less frequent. As a result of the lack of judicial precedents interpreting the provisions of Chapter 9, many issues relating to the application of Chapter 9 are also not fully developed. Notwithstanding the shortage of case experience, in recent years there have been several significant cases that have enhanced the ability to assess the potential impact of Chapter 9,[21] the impact of municipalities seeking to avoid a Chapter 9 filing by negotiating with their creditors, and the impact of using the threat of a Chapter 9 filing as leverage in such negotiations.[22]

This chapter is organized as follows. Section two presents an overview of Chapter 9, with a focus on key elements of Chapter 9 that are shaped by the unique federal structure of the United States. Section three reviews the use of Chapter 9 and focuses on selected cases. Section four analyzes the impact of Chapter 9 and assesses the benefits and limitations of Chapter 9. Section five concludes and points to future areas of research.

Chapter 9: An Overview

Much of the structure of Chapter 9 is shaped by two federal constitutional constraints: the Contracts Clause[23] and the Tenth Amendment to the U.S. Constitution.

The Contracts Clause prohibits the states from passing laws that impair, that is, interfere with, existing contracts. Therefore, states cannot pass laws that would adjust a municipality's debt obligations, in effect impairing the creditors' interests in the debt obligation contracts. This constitutional restriction does not apply to the federal government.[24]

The Tenth Amendment to the U.S. Constitution reserves certain powers to the states regarding the management of their internal affairs. Chapter 9 must balance a bankruptcy court's power to restructure municipal debts with the sovereignty of a state and its municipal entities' ability to control their own affairs. As a result, the bankruptcy court plays a much more limited role in Chapter 9 than in the bankruptcy proceedings of private entities.[25] Although Chapter 9 contains many provisions similar to other chapters of the Bankruptcy Code applying to private entities, Chapter 9 is significantly different. For example:

- Creditors cannot force an involuntary filing, submit their own Plan for the Adjustment of Debts, move for the appointment of a trustee, or contest the decisions of the municipality regarding its property and revenues.[26]

- There is no provision in the law for liquidation of the assets of a municipality and distribution of the proceeds to creditors.
- The bankruptcy court cannot impose taxes.[27]
- The bankruptcy court generally is not as active in managing a municipal bankruptcy case as it is in corporate reorganizations under Chapter 11.[28]
- A municipality must be *specifically authorized* by the state to file for Chapter 9 Bankruptcy.[29]

In addition, state laws governing the activities and finances of municipalities cannot be interfered with. Chapter 9 is respectful of not interfering with a state's control over its municipalities by reserving to the state the power to control its municipalities and limiting the jurisdiction and powers of the Bankruptcy Court.[30]

Eligibility

A *municipality* may only use Chapter 9 of the Bankruptcy Code[31] *and* only a *municipality* may file for relief under Chapter 9.[32] In addition, Chapter 9 requires that the municipality must[33]:

- Be specifically authorized by state law to be a debtor
- Be *insolvent*[34]
- Desire to effect a plan to adjust its debts
- Engage in certain prefiling efforts 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*.[35]

The threshold for seeking bankruptcy protection is higher for a municipality than for a private business entity filing a Chapter 11 petition. In addition, a municipal debtor is subject to fewer constraints in its operations, and the court's role and powers are far more limited. The bankruptcy court cannot take over the governance of the debtor. Nor can the court interfere with the municipality's political or governmental powers or with its properties or revenues. The court cannot order a reduction in expenditures, an increase in taxes, or sales of property.

Due to these limitations on the court's jurisdiction over a municipality, some have argued that Chapter 9 may be used too easily by municipalities since they receive protection from creditors and the creditors are subject to debt adjustment pursuant to a Plan of Adjustment proposed by the municipal debtor, while at the same time the court cannot substantially interfere with municipal affairs, thus creating a moral hazard of abusing the Chapter 9 process. To counter this possibility, Chapter 9 provides for the dismissal of any petition not filed in *good faith*. This *good faith* requirement has been interpreted to mean that the municipal debtor must be attempting to effect a speedy, efficient reorganization on a feasible basis and to prevent the municipal debtor from attempting to unreasonably deter and harass its creditors.[36] Such good faith negotiations must be wary of preferring certain creditors over others, as in the event of bankruptcy such preferred arrangements may be voided. The voiding of preferred arrangements and the recovery of preferred payments, coupled with transparency, public access, and "sunshine," have substantially reduced the problem of nontransparent prefiling negotiations.

The intention to counter moral hazard, or abuse of the protection, also lies behind many other provisions: the insolvency test, for example, is designed to protect creditors and avoid abuse when less drastic remedies are available. The potential moral hazard of a debt adjustment procedure that is too easily available by not inflicting significant penalties on municipal affairs seems to be effectively countered by the stringent eligibility requirements and evidenced by the low use of Chapter 9 by municipalities.

Definition of municipality. The term *municipality* is defined as "a political subdivision or public agency or instrumentality of a State."[37] The definition is broad enough to include cities, counties, townships, school districts, and public improvement districts. It also includes revenue-producing bodies that provide services that are paid for by users rather than by general taxes, such as bridge authorities, highway authorities, and water and sewer authorities.[38]

Although this is a broad definition that clearly includes general purpose municipalities and special service districts, it is not without limitation. In the Orange County bankruptcy, the court held that the Orange County Investment Pool (OCIP) was an instrumentality of Orange County and not of the state; therefore the Investment Pool was not eligible to file under Chapter 9 as a municipality.[39] In addition, a recent case involving the Las Vegas Monorail Company's[40] filing for reorganization under Chapter 11 was challenged by Ambac Assurance Corporation, which had issued a guarantee of the Las Vegas Monorail's outstanding bonds.[41] Ambac argued that the Las Vegas Monorail was a "public instrumentality" of the state of Nevada and as such could only file pursuant to Chapter 9.[42] Although the interest on the Las Vegas Monorail's bonds was exempt from federal income taxation as a public instrumentality of the state, Ambac's motion was denied by the Bankruptcy Court of the District of Nevada.[43] The judge argued that although the Las Vegas Monorail Company had expressly acknowledged itself as an "instrumentality of the state of Nevada" for obtaining the tax exemption on its debt and that it was a company controlled by the Governor of the state of Nevada, the term "public instrumentality" of Chapter 9 was vague and that the Las Vegas Monorail Company did not have sufficient municipal qualities and characteristics to be considered a municipality within the meaning of Chapter 9.[44]

This case demonstrates that the determination of eligibility is not a simple matter and may vary among states.[45] For example, in a case involving New York City's Off-Track Betting Corporation (OTB) filing under Chapter 9, the court found that OTB was a *municipality* since it is a public benefit corporation "created by the State for the general purpose of performing functions essentially governmental in nature."[46]

The eligibility determination is critical because it may be more beneficial for a municipality to have one of its special purpose entities to proceed under Chapter 9 than it would be to proceed under Chapter 7 or Chapter 11. This is because Chapter 9 is more restrictive of creditor rights, reflecting the need to preserve essential public services.

State authorization. A municipality must be specifically authorized by the state to file for Chapter 9 bankruptcy.[47] This requirement of state authorization derives from the Tenth Amendment principle that the federal government may not interfere with states' internal governance. Chapter 9 must respect states' sovereignty over their political subdivisions. While Chapter 9 offers a municipal bankruptcy process, the state authorization requirement leaves to each state the final say over whether and which of its political subdivisions may have access to this process.[48]

A state has significant interests related to its municipalities' filing pursuant to Chapter 9. For example, a state may be concerned that, among other things, the impact of such a filing would limit the access of other municipalities in the state to the credit markets by lowering credit ratings in the state and increasing borrowing costs of all municipalities within the state.[49] However, such state interests do not necessarily coincide with the interests of the municipality. In addition, the state may be a creditor of the municipality. The requirement of state authorization may not be in the best interests of a financially distressed municipality.

States have approached the authorization requirement in several ways. In some states, there is a broad statute that grants filing authority to all municipalities. However, many states—including California, which until recently had such broad authorization[50]—limit which entities can file and under what circumstances, or require special approval of state authorities to permit a filing.[51] Twenty-three states prohibit their municipalities from filing pursuant to Chapter 9.[52] (See table 8.1.)

Table 8.1 State Authorization of Chapter 9 Bankruptcy

Chapter 9 eligible		Chapter 9 ineligible	
Alabama	Missouri	Alaska	New Mexico
Arizona	Montana	Delaware	North Dakota
Arkansas	Nebraska	Georgia	Oregon
California	New Jersey[a]	Hawaii	South Dakota
Colorado	New York	Indiana	Tennessee
Connecticut[a]	North Carolina[a]	Kansas	Utah
Florida	Ohio[a]	Maine	Vermont
Idaho	Oklahoma	Maryland	Virginia
Illinois[a]	Pennsylvania[a]	Massachusetts	West Virginia
Iowa	Rhode Island[a]	Mississippi	Wisconsin
Kentucky	South Carolina	Nevada	Wyoming
Louisiana[a]	Texas	New Hampshire	
Michigan[a]	Washington		
Minnesota			

Sources: Laughlin 2005; Spiotto 2008.[53]

a. States that conditionally authorize municipal bankruptcy.

Insolvency. A municipality must be *insolvent*.[54] Only municipalities filing in Chapter 9 face a statutory requirement of a determination of insolvency. However, because municipal assets are not subject to seizure or liquidation, insolvency of a municipality is not determined by examining its balance sheet but rather is based on cash flow. A municipality either must not be paying its debts when due or must be unable to pay such debts when they become due in the future.[55]

Determination of a municipality's insolvency requires a comprehensive cash flow analysis of factors including multiyear cash flows, available reserves, ability to reduce expenditures or borrow, and legal options to postpone debt payments. The municipality is expected to continue to operate and provide at least a minimal level of services.

A municipality's taxing capacity also enters into the analysis of insolvency. Although a municipality need not exercise its taxing authority to the fullest extent to be insolvent, a failure to consider any reasonable tax increase may lead a court to conclude that the *good faith* requirement (discussed under Eligibility) has not been met. In a case involving Bridgeport, Connecticut, the court held that the city, which had chronic financial problems, a US$16 million annual deficit, and the highest effective tax rates in the state, was not insolvent because it had not exhausted its financing power and, therefore, could not demonstrate that it would run out of funds in the next fiscal year.[56]

Commencement of Chapter 9: Automatic Stay and Revenue Bond Preference

One of the most important and immediate advantages of a Chapter 9 filing is the protection from legal actions that might be taken by creditors.[57] The automatic stay prohibits the continuation of creditors' lawsuits and the exercise of remedies against a debtor until the creditor obtains relief from the stay.[58] This protection provides the municipality with a period of time to deal with its financial crisis and to conduct negotiations without having to deal with legal claims of creditors.

Different types of bonds receive different treatment in municipal bankruptcy cases. General obligation bonds are treated as general debt in Chapter 9 cases. During the period of the automatic stay the municipality is not required to make payments on general obligations bonds. The obligations created by general obligation bonds are subject to negotiation and possible restructuring under the Plan of Adjustment.

Special revenue bonds,[59] by contrast, will continue to be secured and serviced to the extent that special revenues are available after the payment of the operating expenses of the project or system from which the revenue is derived.[60,61] Such revenues may be applied to payments coming due on special revenue bonds without violating the automatic stay.[62]

Although general obligation debt constituting the full faith and credit of a municipality may be generally viewed as the best credit a municipality can offer a creditor, in a Chapter 9 proceeding, debt secured by a single, limited, special revenue, having a protected status from impairment, may have a preferred credit status.

Plan of Debt Adjustment

Chapter 9 provides the municipal debtor with a means to refinance or reduce its debt and to obtain relief from burdensome contractual obligations, such as collective bargaining agreements. At the time a municipal debtor files for Chapter 9,[63] it must file a disclosure statement and a plan for the adjustment of its debts. The disclosure statement and the Plan of Adjustment are sent to the creditors for a vote. The Plan of Adjustment is proposed by the municipal debtor and submitted to the court and must be *fair and equitable* and *in the best interests of the creditors*.[64]

Executory contracts. The Plan of Adjustment may include, and the court may approve, the assumption or rejection of executory contracts.[65] The municipal debtor can assume unexpired leases and executory contracts that are beneficial and reject those that are burdensome.[66] For many municipalities the financial obligations associated with labor agreements and pensions are a substantial source of the financial distress. (For example, see the discussion of Vallejo, California, later.) Labor agreements and pension obligations are subject to an assumption or rejection in Chapter 9.[67,68]

Debt adjustment. In addition to the automatic stay, a significant benefit of Chapter 9 is that the bankruptcy court has the power to approve the Plan of Adjustment over the objection of creditors so long as the requisite majorities of creditors holding similar claims have approved the Plan and so long as the Plan does not discriminate among holders of similar claims.[69] In order to be confirmed, the Plan of Adjustment must be accepted by one-half in number and two-thirds in amount of each class of claims that is impaired under the Plan of Adjustment.[70] This provision was one of the primary motivations behind the enactment of Chapter 9.[71,72]

The Plan of Adjustment can impair the rights of holders of secured and unsecured debt. A vote of a majority of each class of debtor will bind dissenting creditors in that class. Notwithstanding a rejection by a class, if at least one impaired class approves the plan, the court may confirm the plan, forcing creditors to go along with a plan they have not accepted.

The bankruptcy court's role is limited to the acceptance or rejection of the plan. However, the court must still determine that the plan is *fair and equitable*, *feasible*, and *in the best interests of the creditors*.[73] Feasibility of a plan would be based on the expectation that the municipality is capable of carrying out the plan.[74] The *best interests of the creditors* is a more ambiguous standard. The test has been interpreted to mean that the plan must be better than other alternatives available to the creditors. In a Chapter 9 case, the alternative would be dismissal of the case, leaving a chaotic situation in which every creditor must fend for itself. An issue of some ambiguity is the extent to which the best interests test requires a municipality to raise taxes in order to meet debt obligations. The Supreme Court has held that the fairness of a plan cannot be evaluated without specific findings on a district's ability to pay bonds with tax revenues.[75] Determining the point to which taxes can be effectively raised is difficult. At some point tax increases will result in a decreasing collection rate, causing a decline in tax revenues.[76] In addition, the Plan of Adjustment must comply with state law that may be different in each state. For example, in the recent Chapter 9 filing by Central Falls, Rhode Island, a provision of a recent Rhode Island law providing that bondholders are to be paid first became a contentious issue with other creditors such as the pension funds and labor unions.[77]

Bankruptcy Courts: Restricted Powers

Chapter 9 is designed to recognize state sovereignty and the court's limited power over operations of the municipal debtor[78] by restricting the power of the bankruptcy court to interfere with:

- Any of the political or governmental powers of the municipality
- Any of the property or revenues of the municipality

- The municipality's use or enjoyment of any income-producing property unless the municipality consents or the plan so provides.

These provisions clearly provide that the municipality's day-to-day activities are not subject to court approval and that the debtor may borrow money without the court's approval.[79] In addition, the court cannot appoint a trustee (except for limited purposes[80]) and cannot convert the case to a liquidation proceeding.[81, 82]

If the Chapter 9 proceeding fails to produce a Plan of Adjustment acceptable to the bankruptcy court, the case will be dismissed and the relationship between the municipality and its creditors will continue as before the Chapter 9 filing, with whatever remedies are available to the municipality and its creditors under state law. Dismissal of the case without the approval of a plan puts the municipality in a difficult situation, because the municipality remains unable to pay its debts and is now without the protection of the automatic stay. The power of the bankruptcy court to reject the plan and force the municipal debtor and creditors into the maelstrom and unpredictability of litigation is the only, although substantial, leverage that the bankruptcy court has in Chapter 9.

Use of Chapter 9

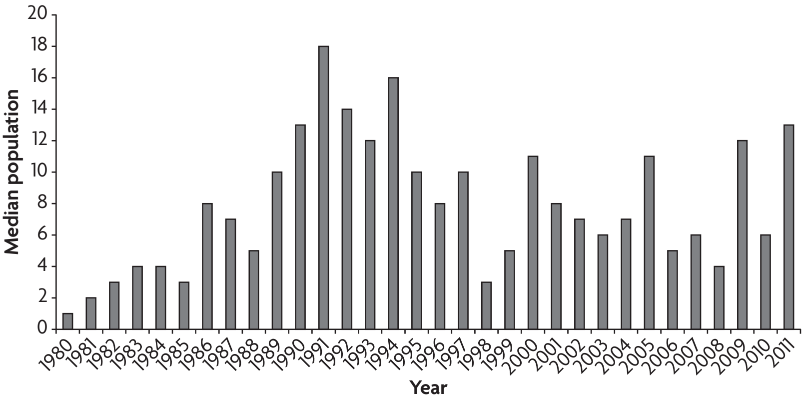
Statistics on Chapter 9 Use

There were approximately 600 municipal bankruptcy filings from 1937 to 2011.[83] For bankruptcy practitioners, this number is small, and the use of the law is often described as "rare." For example, in 2010 there were only 6 Chapter 9 filings compared to 56,282 business bankruptcy filings.[84]

As shown in figure 8.1, from 1980 to 2011, there were 252 Chapter 9 petitions filed, or about eight filings annually. The annual number of filings peaked in 1990 at 18, while there was only one filing in 1980, the lowest number.

One crucial feature of Chapter 9 use is that most filings are not by general purpose municipalities, but by municipal utilities, special purpose districts, and other types of municipalities. From 1980 to 2007,

Figure 8.1 Annual Chapter 9 Filings, 1980–2011



Sources: 1980–2010 data are from the American Bankruptcy Institute, http://www.abiworld.org; 2011 data are based on cases recorded at http://www.pacer.gov.

only 17.5 percent of Chapter 9 filings were from general purpose municipalities—cities, villages, or counties—while 61.8 percent were from utilities and special purpose districts.[85] Other Chapter 9 filers were mainly schools, public hospitals, and transportation authorities.[86] Only four of the 13 Chapter 9 filings in 2011, for instance, are from general purpose municipalities, including Boise County, Idaho; the city of Central Falls, Rhode Island; the city of Harrisburg, Pennsylvania; and Jefferson County, Alabama.[87]

From 1980 to 2007, more than 60 percent of filings were concentrated in four states: California, Colorado, Nebraska, and Texas. Nebraska had 39 Chapter 9 filings from 1980 to 2007, the highest number, followed by Texas with 33 filings, and California and Colorado, with 22 filings each.[88]

Close scrutiny reveals that most general municipalities that filed for Chapter 9 tend to be small entities. Based on cases recorded in Public Access to Court Electronic Records (PACER), the population median is 1,305 for those that filed, and more than 75 percent had a population of less than 10,000.[89] This fact, coupled with the frequently observed state involvement in the fiscal distress of large municipalities, may support the hypothesis that states tend to aid big municipalities and would not allow them to go broke.

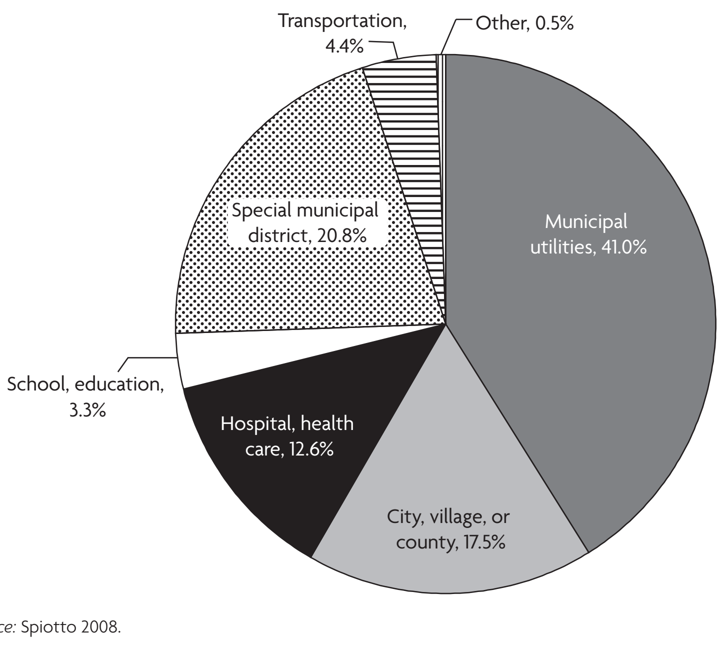
Five general purpose municipalities filed under Chapter 9 twice, but refiling is rare for other types of municipalities.[90] Three of the five refilings occurred in 2009, highlighting the impact of the recession on local government finances and the potential for revisiting Chapter 9 by previous filers (see figure 8.2).[91]

From 1937 to April 2012, 162 of 636 of the Chapter 9 filings, or approximately 26 percent, have been closed or dismissed without a plan of adjustment being filed. Since 1980, 81, or approximately 31 percent, have been dismissed or closed without a plan of reorganization of the filings (Spiotto 2012).

Selected Chapter 9 Cases

Below are brief descriptions of important Chapter 9 cases, of recent municipal experience with Chapter 9, and of municipalities considering Chapter 9. They illustrate different origins of Chapter 9 filing and reflect applications of the Chapter 9 framework.

Figure 8.2 Chapter 9 Filings by Type of Municipality, 1980–2007



Source: Spiotto 2008.

Until 2010, Orange County, California, was the largest municipal bankruptcy in the United States. However, Jefferson County, Alabama, which filed for bankruptcy in 2011, is now the largest to file a petition under Chapter 9. Both municipalities experienced fiscal distress as a result of the use of certain derivative debt instruments. Vallejo, California, is an example of a municipality financially burdened by labor agreements and pension obligations in the face of continuing economic decline. Harrisburg, Pennsylvania, the state capital, is experiencing financial distress as a result of a guaranty that it issued on the debt of a local authority used to build an incinerator. Westfall, Pennsylvania's financial distress was the result of a one-time liability judgment, and its Chapter 9 experience appears to have been efficient and effective.

Orange County, California. Orange County, California, was one of the fastest growing, richest counties in the United States and, as mentioned, was, at the time, the largest municipality in U.S. history to file for Chapter 9 bankruptcy, in 1994.[92]

At the time of its bankruptcy, the county was the fifth-most-populous county in the United States, with 2.5 million residents, had a budget that exceeded US$3.7 billion, and employed about 18,000 people.[93]

As a result of the restrictions imposed by the California Constitution[94] on the ability of local governments to raise local tax revenues, and the increasing demand for high-quality public services, public officials have been tempted to search for creative solutions to these challenges.[95] The County Treasurer was in charge of the OCIP, which invested funds of Orange County and of more than 200 other local public agencies including 31 cities, regional transportation agencies, local school districts, local water agencies, sanitation districts, and many small local agencies. The OCIP had assets of US$7.6 billion in 1994 that were invested in derivative instruments and high-yield long-term bonds. In addition, the OCIP borrowed US$2 for every US$1 on deposit, creating total liabilities of US$20.6 billion. As a result of market conditions that devalued OCIP investments, by November 1994, the OCIP had lost US$1.64 billion.

Awareness of the situation caused many Wall Street firms to commence legal actions to seize collateral, that is, the remaining assets of the OCIP. Orange County filed for Chapter 9 in December 1994 to avail itself of the automatic stay protection of Chapter 9. The filing did not stop the creditors' legal proceedings against the OCIP assets held as collateral by banking institutions, but it froze OCIP funds, preventing withdrawals and causing severe distress for Orange County and the local agencies that had invested their funds with it.

Both Orange County and the OCIP filed for Chapter 9 bankruptcy. The OCIP filing was rejected by the bankruptcy court based on a determination that it was not a *municipality* pursuant to Chapter 9 (see the discussion on Eligibility). Orange County initially submitted a Plan of Adjustment (Plan A) that called for an increase of one-half percent in the sales tax. Such an increase was subject to voter approval pursuant to California law, in effect requiring voter approval of Plan A. Voters overwhelmingly rejected the increase. Orange County then developed Plan B, which was substantially based on forbearance by the local public agencies that had invested in the OCIP and their willingness to seek reimbursement of their investment losses from the results of litigation by Orange County against the banking institutions and other professionals involved with the OCIP.[96]

Plan B also provided for refinancing the outstanding county debt. This was accomplished in June 1996 while Orange County was still in bankruptcy, through the issuance of US$880 million in 30-year bonds that were insured by a municipal bond insurer. This refinancing permitted Orange County to exit Chapter 9 by the end of June 1996.

Much of the impact of Plan B was felt after Orange County exited from bankruptcy.[97] This huge amount of debt for Orange County prevented the county from borrowing for other purposes, and the transfer of certain revenue sources to the payment of the debt put substantial stress on the Orange County budget. The Orange County budget constraints, together with an US$850 million shortage for local public agencies that had invested in the OCIP, resulted in severe budget cutbacks by Orange County and the investor local public agencies. Many of the local public agencies[98] that were OCIP investors were deliverers of public services, such as school districts, utilities, and health care and other social services. Most of the resulting budget cuts were in public protection, general government services, and community and social services. The impact fell disproportionately on the poor[99] since they are more dependent on county government programs. There were large budget cuts in social service agencies that serve the poor and cuts in basic infrastructure and transportation programs, and user fees for services were increased.[100]

The Orange County bankruptcy was precipitated by a risky investment strategy rather than a shortage of tax revenues and increased spending. The county emerged from Chapter 9 18 months later, in June 1996, and at that time sold US$880 million of insured bonds needed to refinance its debts. From the perspective of the current county treasurer, bankruptcy was beneficial; Orange County was insolvent and bankruptcy allowed it to reduce its debt to an affordable level and begin a path to sound fiscal health. Just two years after filing, it had access to the lending markets, and seven years after filing it had an AA bond rating. The downside was the risk to its reputation.[101]

The Orange County bankruptcy was both orderly and quick. Within 18 months, a Plan of Adjustment had been adopted that called for full repayment of creditors' claims (excluding lost interest and the forbearance of the shortfall to the local public agencies, which would be paid to the extent of amounts recovered as a result of litigation against the banking institutions and other professionals involved in the OCIP). This probably would not have been possible without the automatic stay on litigation and the financial relief provided by the suspension of payments to creditors during the stay.[102] Chapter 9 appears to have been sufficiently flexible to accommodate the operational needs of the county and the interests of its creditors.[103]

City of Vallejo, California. Vallejo, a community of 120,000, is the largest California city, by population, ever to file for Chapter 9 bankruptcy, and the only general purpose municipality to do so in California since 2001. Vallejo's finances have long been dominated by the costs of its labor agreements, and its distress was caused not by a debt issue but by a budget issue, that is, a long-term structural imbalance that was the result of a declining economic base, decreased revenues from property and sales taxes, cuts in funds from the state, and labor contracts that were out of line with the city's budget realities.[104] This trend was exacerbated by the recent economic slowdown. A large part of Vallejo's fiscal problems had to do with diminishing revenue; city tax collections plummeted from US$83 million during 2007–08 to US$65 million during 2010–11, a result of the recession and the housing bust. Housing values have fallen an astonishing 67 percent.[105]

Pension liabilities and financial obligations per labor contracts are by far Vallejo's largest debt. Prior to filing for Chapter 9, Vallejo had negotiated with several of its labor unions but was unable to reach an agreement. Vallejo filed for Chapter 9 bankruptcy in May 2008.[106]

Vallejo submitted a Plan of Adjustment it deemed feasible at the time and sought to adjust its labor contracts. The labor unions challenged the right of the bankruptcy court to approve a plan that abrogated their collective bargaining agreements. The court ruled that such executory labor contracts can be voided in a Chapter 9 proceeding.[107] Since the court decision, Vallejo has negotiated contracts with three of its four labor unions.[108]

During the bankruptcy proceedings, Vallejo continued to make all payments on its non-General Fund obligations (including water revenue bonds, tax allocation bonds, and assessment and improvement district bonds) on time and in full. The majority of this debt, approximately US$62 million, consisted of water revenue bonds, which were paid from the net revenues of the city's water enterprise. Payments on General Fund debt service, however, were paid at less than contractual rates.

During the Chapter 9 proceedings, the city's finances continued to deteriorate.[109] The feasibility of the original Plan of Adjustment diminished over time and municipal officials had to renegotiate further concessions from its unions.[110]

After spending three years and five months in Chapter 9 proceedings, the bankruptcy judge approved Vallejo's revised five-year Plan of Adjustment and its exit from Chapter 9 in November 2011.

Vallejo has closed fire stations; cut funding to senior centers, libraries and public works; eliminated minimum staffing requirements for the fire department; and sought new sources of revenue. Among other changes, city workers now contribute more to their health insurance, pension benefits are reduced for new employees, and pension contributions by current workers are increased. Pension benefits for current retirees were not changed.[111] The Plan does not adjust debt that is secured by designated revenue sources, such as water revenue bonds, and it restructures the debt owed to unsecured creditors, which will receive between 5 and 20 percent of their claims over two years.[112]

Unlike Orange County, Vallejo's bankruptcy process has not been quick, and unlike Orange County, where the distress was precipitated by a one-time event, the financial distress of Vallejo is based on structural fiscal imbalance, which was exacerbated by the economic decline. The Chapter 9 process does not seem to be as effective at resolving this type of fiscal distress. The process took more than three years at a cost of approximately US$9.5 million in legal fees.[113] Despite its limited effectiveness, bankruptcy has enabled the control of wage cost and pension liabilities, which account for more than three-quarters of Vallejo's General Fund spending.[114] However, Vallejo continues to face fiscal challenges.

Jefferson County, Alabama. Jefferson County, Alabama's most populous county, which includes Birmingham,[115] filed for Chapter 9 bankruptcy in November 2011 and has become the largest municipal bankruptcy in U.S. history. The filing is to resolve the overindebtedness of the county's sewer system—a special purpose vehicle. The sewer system, since inception in 1994, has suffered a structural imbalance in revenue and expenditure. The city resorted to structured financial products to reduce debt service obligations. However, the 2008–09 global financial crisis destabilized the market for such debt instruments.

The county began a sewer restoration and rehabilitation program in 1994. That effort, initially estimated to cost US$1 billion, grew into a US$3.2 billion project to rebuild and expand the system.[116] Jefferson County issued US$3.2 billion in bonds to finance the project.

The county's bankruptcy filing represents that sewer rates in Jefferson County increased 400 percent. In an attempt to reduce debt service costs while limiting increases in tariffs, the county swapped its long-term fixed higher interest rate into a short-term variable rate by entering into interest rate swap agreements. The 2008–09 financial crisis destabilized the market for such debt instruments, resulting in increased debt service largely as a result of financial market illiquidity.[117] In 2008, Jefferson County defaulted on its sewer debt payments, which resulted in an acceleration of the debt.[118]

The county had also been hurt by the loss of an occupational tax that brought in 44 percent of its discretionary revenue. The state Supreme Court ruled the tax unconstitutional in 2011, and the county has laid off hundreds of employees as a result.[119]

Unlike the city of Harrisburg, Pennsylvania (see below), where the state of Pennsylvania moved swiftly to intervene in the city's financial situation, the state of Alabama has resisted providing any assistance to Jefferson County.[120]

Jefferson County had been considering filing for bankruptcy pursuant to Chapter 9 for several years.[121] In lieu of such filing, it reached a forbearance agreement[122] with creditors in 2009 while it negotiated with creditors.[123] The governor and a majority of council members supported the negotiation of the debt in lieu of Chapter 9 filing because they wanted to avoid the "stigma" of bankruptcy. However, the possibility of a Chapter 9 filing and the desire of both the county and creditors to avoid Chapter 9 was part of the dynamic of these negotiations,[124] which revolved around[125]:

- Writing down a significant portion of the sewer debt
- Restructuring the remaining debt at fixed rates
- Limiting sewer rate increases to the rate of inflation.[126]

However, in November 2011, the negotiations were suspended and the county filed for Chapter 9 bankruptcy. This bankruptcy proceeding will raise several legal issues relating to Chapter 9, including but not limited to the issue of application of special revenues, pledges, and statutory liens, which have real significance to the municipal market.

Harrisburg, Pennsylvania. Debt issued by a special purpose vehicle for an incinerator plant was guaranteed by the city of Harrisburg, Pennsylvania, the capital of the state. Projections for the construction and operation of the plant were not met and forecasts of the revenues that would be generated were overly optimistic. As a result, the special purpose vehicle defaulted on its debt, and the guaranty of Harrisburg was activated. In 2010, Harrisburg owed US$68 million in interest payments, US$3 million more than its entire annual budget.[127]

Harrisburg sought forbearance by its principal creditor[128] for time to negotiate a settlement.[129] The mayor resisted filing for Chapter 9;

however, the governor has vowed that the state will not bail out the city, and the city controller considered Chapter 9 bankruptcy the city's best option.[130] The option of Chapter 9 bankruptcy was part of the dynamic of the negotiations with creditors.

Notwithstanding the negotiation efforts, on October 11, 2011, the Harrisburg city council authorized the filing for Chapter 9 bankruptcy amidst discord among state officials, the city council, and the mayor. In November 2011, the bankruptcy filing was dismissed by the court as not having been properly authorized by Harrisburg.[131] The dismissal leaves the state to move forward on its takeover of the city's finances. The state governor has asked a state judge to appoint a receiver for the city pursuant to state intervention procedures for municipalities in fiscal distress.[132]

Westfall, Pennsylvania. Westfall, Pennsylvania, with a population of 2,400 and an annual budget of US$1.5 million, faced an unusual US$20 million expense from a legal judgment obtained by a property developer whose civil rights were violated. Westfall tried to negotiate with the developer, who was willing to reduce the debt some, but not enough for the township to be able to pay.[133] In April 2009, the township learned that the developer planned to file a mandamus order to force Westfall to make the payments. On April 10, 2009, Westfall filed for bankruptcy.[134]

The Plan of Adjustment submitted by Westfall and approved by the bankruptcy court reduced the claim to US$6 million to be paid over 20 years with no interest. To pay the US$6 million legal settlement owed to the housing developer, township officials increased property tax rates on the community's residents by 48 percent—a rate that will drop gradually over the 20-year repayment period. Westfall's attorney believes that the developer agreed with the plan because the judge might have crammed down a less favorable plan if there was a fight in bankruptcy court. The judge cannot cram down a plan unless at least one class of creditors agrees to the plan. In Westfall's case, even though it was only one developer who was owed money, Westfall owed three other parties smaller sums. They all agreed to the plan even though the developer initially did not. Before Westfall filed for bankruptcy, it was known that at least one class of creditor would likely go along with the plan.[135]

The financial distress precipitated by a one-time event was effectively dealt with by the Chapter 9 proceeding.

Prichard, Alabama. Prichard, which is located outside of Mobile, has a population of 25,000—half the population it had 50 years ago. It is a classic case of a dying city, owing to, among other things, the closure of a military base, the shift in business and commerce to Mobile suburbs, and declining property values. Only the poorest citizens in the Mobile area live in Prichard, which has created challenging social problems. Housing infrastructure and law enforcement became serious problems.[136]

In October 1999, Prichard filed for Chapter 9 bankruptcy when it was unable to pay US$3.9 million in delinquent bills. In addition, Prichard admitted that it had not made payments into its employees' pension fund for years and had withheld taxes from employees' paychecks, but had not submitted the withholdings to the state and federal governments.

In the years following the bankruptcy filing, Prichard made some progress enhancing social, financial, and technological growth, as well as economic development. Its 2001 budget predicted a 4 percent increase in revenue over its 2000 budget, and the city exited from bankruptcy in 2001.

Although Prichard had some success in revising its budget, so that it no longer operated at a deficit, it was not able to meet its pension obligations. Prichard filed for Chapter 9 bankruptcy for the second time on October 27, 2009, eight years after exiting the previous Chapter 9 filing. In its filing, Prichard claimed a US$600,000 deficit in the prior fiscal year's US$10.7 million budget. In addition, it owed a US$16.5 million payment to its pension fund under the earlier Chapter 9 settlement. Prichard was being sued by its pensioners for failure to make pension payments for six months, and filed for Chapter 9 to "stay" those proceedings.[137]

On August 31, 2010, the bankruptcy court rejected Prichard's filing for Chapter 9 protection on a technical interpretation of the requirement for Alabama's consent for municipalities to file for Chapter 9. The court ruled that only municipalities with bonded debt may file. Prichard does not have any outstanding bonds. Prichard has filed an appeal of this decision.[138]

Impact of Chapter 9

Although Chapter 9 continues to be rarely used by municipalities,[139] there has been a marked increase in both interest in Chapter 9 by financially distressed municipalities and concern by creditors and rating agencies about municipalities filing for Chapter 9.[140] A number of factors may contribute to the scarcity of cases. They include:

- The threshold requirements for Chapter 9 eligibility are substantial, including the prohibition and limitations by states for a municipality to file for Chapter 9.[141]
- Municipalities are not exposed to some risks that lead private creditors to seek bankruptcy protection; for example, their assets are not subject to seizure.
- Municipalities are concerned about the stigma effect of bankruptcy on their ability to borrow and the cost of such borrowing, and the public perception of the municipality.
- Municipal officials may be wary of the political stigma of a bankruptcy filing, that is, constituents may link the bankruptcy to officials' policies and behaviors.[142]
- State intervention programs exist in some states, which could be effective in the sense that states could force tough fiscal adjustment-tax increases and service cuts that cannot be imposed by the court in a Chapter 9 proceeding.[143]
- The process is expensive.

In addition, it is apparent that the availability of Chapter 9 to municipal debtors has an impact on the dynamic of forbearance by, and negotiations with, creditors.[144] Chapter 9 may have a substantial impact in its avoidance, even if rarely used. Even when used, it is clear that Chapter 9 is perceived as a last resort to deal with a municipality's financial distress after all other options have been explored, including available state remediation.

An analysis of Chapter 9 must recognize the following basic, unique principles not common to other chapters of the Bankruptcy Code that put the municipal debtor in an advantageous position:

- Municipalities are not subject to liquidation or strict judicial control.
- The Plan of Adjustment is proposed by the municipal authority.

- The municipal authority does not need judicial permission to exercise governmental functions.

Pros and Cons of Chapter 9 Bankruptcy

Fiscally distressed municipalities may turn to a number of options short of default or bankruptcy to put their fiscal house in order. These include (a) cutting expenditures, (b) raising taxes, (c) postponing payment of obligations, (d) drawing down reserves, (e) renegotiating debt obligations to reduce or defer payments, and (f) borrowing from government entities or commercial lenders.[145]

However, Chapter 9 bankruptcy may benefit a municipal debtor in several ways:

- It provides immediate relief by "staying" the municipality's obligation to make payments on debt other than special revenue bonds; that is, it stops the run on municipal funds.
- It provides immediate relief from legal actions being pursued by creditors.
- It provides a means of obtaining long-term relief, including reduction in debt and other obligations, which will bind a dissenting minority if a majority of creditors consent.
- It may protect a municipality and its residents from untenable levels of taxation by blocking creditor lawsuits from seeking to force officials to raise taxes to support debt service.
- Since postfiling borrowing to support a municipality's operations is given a higher priority than prefiling borrowings, it may in some cases facilitate new borrowing.
- It provides the ability to renegotiate contract agreements and pension plans.
- It provides a municipal debtor with a single forum in which to consolidate and address each of its various issues under the expert supervision of a bankruptcy judge.

A Chapter 9 filing also comes with potentially significant costs including costs associated with retaining legal and financial professionals to administer the case, complying with court requirements, and negotiating with creditors. Moreover, any municipality engaged in a Chapter 9 proceeding faces the unpredictability innate in legal proceedings. This unpredictability may be a substantial factor in Chapter 9, a result of the uncertainty owing to limited case law relating to the interpretation of its provisions.

One of the most cited reasons to avoid Chapter 9 has been the alleged "stigma" of bankruptcy and the need of a municipality to have access to the credit markets that would arguably be limited, or available at an increased cost, by the stigma of bankruptcy.[146] Access to credit is a serious issue for a municipality faced with major infrastructure needs. It affects not just creditworthiness but the perception of life in the city and the economic vitality of the city for years to come.[147]

However, distressed municipalities have been able to gradually return to the credit markets. For example, New York City returned to the credit markets six years after its fiscal crisis, and Cleveland returned five years after its 1978 default.[148] Orange County was able to access the credit markets almost simultaneously with its exit from Chapter 9, 18 months after filing for Chapter 9.[149]

This experience raises the question of whether the stigma of bankruptcy is exaggerated by creditor interests fearing debt adjustment or loss of control over the debt adjustment process. Is it the bankruptcy procedure more than the fiscal distress that may increase future borrowing costs? That is, is the impact of Chapter 9 worse than the impact of default? If and when Jefferson County determines to return to the credit markets, will it be treated less favorably as a result of a Chapter 9 filing than as a result of its default and negotiated debt adjustment with its creditors? A Chapter 9 filing is not the cause of the fiscal problem but the result of not being able to resolve them any other way. Orange County's experience may indicate that a municipality's putting its financial house in order is more important to accessing credit markets than the process used to achieve financial well-being.[150]

Can Chapter 9 Save Fiscally Stressed Municipalities?

If the primary objective of a financial distress mechanism is to provide a process to develop a solution to the financial difficulties of a municipality that can be sustained over time, the effectiveness of Chapter 9 may depend on the underlying causes of the financial distress. The cases seem to indicate that many of the Chapter 9 filings are by municipalities that have experienced one-time events, for example, Orange County's use of strategic investments, and Westfall Township's liability for a legal judgment to a property developer. The Chapter 9 process seems to have been effective in these cases by providing a mechanism for debt adjustment and protection from legal proceedings. These municipalities have exited from Chapter 9. Orange County has since accessed the credit markets and currently enjoys an AA credit rating.[151]

In contrast, Vallejo's financial distress is the result of systemic budget distress, and notwithstanding concessions made by some of its creditors, it remained in Chapter 9 for more than three years as its fiscal condition continued to deteriorate and it incurred substantial administrative and legal costs.[152]

In addition, there is some evidence that the municipalities that have filed more than once for Chapter 9 did so as a result of systemic budget problems. For example, the city of Mack's Creek, Missouri, filed for Chapter 9 in 1998, then for a second time in 2000, and contemplated bankruptcy again in 2004.[153] The city of Prichard, Alabama, filed for Chapter 9 in 1999, exited from Chapter 9 in 2007, and filed for Chapter 9 again in 2009 (see section on Prichard). Without addressing the cities' core problems, the Chapter 9 process seems to have little impact on reversing the structural fiscal decline without debtors undertaking sustained fiscal consolidation.

Many of the potential remedies for systemic fiscal distress relate to the political and governmental management of municipalities that a court in Chapter 9 procedures is restricted from interfering with. Chapter 9 procedures do not operate in such a manner as to be able to force reform, facilitate reorganization, impose taxes, cut expenditures, or enable other interventions that may interfere with state sovereignty. The role of state intervention procedures and the active participation of market players may have more authority to impose such changes than Chapter 9.[154]

Fiscal stress related to a one-time problem appears to be more susceptible to resolution through the debt adjustment procedures of Chapter 9. Fiscal stress related to ongoing structural deficits is more difficult since Chapter 9 has limited impact on solving the underlying structural problems. Although Chapter 9 can facilitate fiscal adjustment, it lacks the authority to compel budgetary decisions that are under the purview of the executive and legislature.

Conclusion

The design of the Chapter 9 legal structure is specific to the U.S. legal system and is largely determined by the need to comply with the Tenth Amendment to the U.S. Constitution. However, the issues and objectives of a legal framework to resolve financial distress are common across many countries, that is, the public nature of municipalities, the interest in the functioning of local government autonomy, safeguarding essential public services and the assets that provide such services, transparent procedures, the interests of creditors, and functioning subsovereign capital markets. Strategic default by municipalities is a potential risk. The effective design of the insolvency procedure can deter strategic default but also allow a debt adjustment with less risk for moral hazard. The issues of maintaining essential services and assets and limited interference with the authority of democratically elected local officials must be dealt with in any public entity insolvency procedure. This represents a delicate balance of interests. The economic reality is that if creditors are not treated fairly in an insolvency proceeding, they may severely limit their lending to the municipal sector.

In addition, the U.S. Chapter 9 system is based on a respected, independent, and competent judiciary that has the authority to reject a municipality's Plan of Adjustment. This role of the judiciary in many countries may not be appropriate given the development of a country's judiciary. Other jurisdictions have relied on more administrative procedures or a combination of administrative and judicial procedures.[155]

In the municipal sector, bankruptcy is considered a remedy of last resort. However, when all other options have been exercised and have failed, it is useful to have access to this process. Municipal bankruptcy is not a perfect solution for a municipality's fiscal problems, but it can provide breathing room while other long-term options are pursued, and can provide the important element of debt adjustment. Municipalities must continue functioning, and temporary or partial relief from debt obligations can make a difference, particularly when the cause of the financial distress is a one-time event.

Chapter 9 appears to be less effective in providing a solution to municipalities facing long-term, endemic problems involving erosion of the tax base, loss of manufacturing jobs, and a decaying infrastructure, all of which will require substantial funding and significant structural changes that go beyond the scope of Chapter 9.

Notwithstanding this limitation, insolvency proceedings and debt adjustment are legitimate tools in a regulatory framework of subnational debt management and should be considered by municipalities experiencing financial distress. Limitations and implications must be carefully evaluated, notwithstanding the advantages of suspending legal actions by creditors, debt adjustment, reducing the holdout problem, and access to new financing. An insolvency system such as Chapter 9 is an important part of a regulatory framework of subnational financial management that strengthens ex-ante borrowing regulation. As shown by Liu and Waibel (2009), ex-ante rules for debt procedures are not sufficient without an ex-post insolvency mechanism that manages efficient debt workout and facilitates fiscal adjustment.

Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

1. Subnational refers to all tiers of governments and public entities below the federal government or central government. This chapter focuses on insolvency of municipalities in the United States. In broader terms, municipal bonds in the United States include bonds issued by states, local governments, and special purpose vehicles of states or local governments. For the purpose of Chapter 9, subnational governments applies only to local governments that are political subdivisions of states. Therefore, this chapter refers solely to municipalities, that is, local governments.
2. Moody's U.S. Public Finance, *Moody's Assigns Negative Outlook to U.S. Local Government Sector*, 2009.
3. A substantial problem facing municipalities today is the shortfall in public pension funds—estimated to be between US$1 trillion and nearly US$4 trillion nationwide. In California alone, the shortfall could be as high as US$500 billion. Howard Bornstein, Stan Markuze, Cameron Percy, Lisha Wang, and Moritz Zander, "Going for Broke: Reforming California's Public Employee Pension Systems," SIEPR Policy Brief, April 2010, at 2.
4. Council of Europe Recommendation No. 96 (3) "the consequences of financial difficulties among local authorities should be made clear, for example in a municipal bankruptcy code."

5. Municipal Bankruptcy is covered by Chapter 9 of the United States Bankruptcy Code (11 U.S.C. Sec. 901 et seq.).
6. See discussion below as to the definition of municipalities that are eligible to file pursuant to Chapter 9.
7. Robin Jeweler, *Municipal Reorganization: Chapter 9 of the U.S. Bankruptcy Code*, Congressional Research Service, March 8, 2007.
8. See, for example, Gary Kaplan and Joel Moss, "Distressed Cities See No Clear Path: Health, Pension Obligations Threaten Fiscal Crisis," *National Law Journal*, March 6, 2006, at S1; Mary Williams Walsh, "Once Safe, Public Pensions Are Now Facing Cuts," *New York Times*, Nov. 6, 2006 at A1; and "Paying Health Care From Pensions Proves Costly," *New York Times*, Dec. 19, 2006 at A1. Estimates of public pension liabilities for states and local governments range from US$1 trillion to US$3 trillion. "The $2 Trillion Hole," by Jonathan Laing, *Barrons*, March 15, 2010.
9. *Municipal Bankruptcy—A Story in Search of a Trend?*, by Chris Hoene, March 13, 2010; The Official Blog of the National League of Cities; "The Perils of Considering Municipal Bankruptcy, Special Report," January 27, 2010, *Fitch Ratings*; "Muni Threat: Cities Weigh Chapter 9," *Wall Street Journal*, February 18, 2010.
10. Recent filings by Central Falls, Rhode Island; Harrisburg, Pennsylvania; and Jefferson County, Alabama and have raised the profile of Chapter 9 as an option for municipalities in fiscal distress. See Paul Maco et al. (2011). International legal scholars have suggested that the principles of Chapter 9 may be appropriate for sovereign bankruptcies. See Raffer, "Internationalizing U.S. Municipal Insolvency; A Fair, Equitable and Efficient Way to Overcome Debt Overhang," 6 *Chicago Journal of International Law* 361 (2005).
11. A *mandamus* is a court order obliging public officials to take a certain course of action. For a description of mandamus, see McConnell, Michael W. and Randall C. Picker, "When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy," *University of Chicago Law Review* Vol. 60, No. 2 (Spring, 1993) pp. 425–495.
12. The general rule is that "public property" dedicated to a public use is not subject to debt foreclosure. In practice, very little property falls into the "proprietary" category. This argument may also apply to funds in the public treasury accounts to be applied to public purposes. See McConnell, *supra*, note 11 p. 431, 433, 444.
13. House Report No. 95-595, 95th Congress, 1st Session 263 (1977), U.S. Code Cong. & Admin. News 1978 pp. 5787, 6221.
14. Authors' estimation based on "Bankruptcy Basics" (2006) by Administrative Office of the United States Courts and the American Bankruptcy Institute. 2007 U.S. Census. http://www.abiworld.org/; and Public Access to Court Electronic Records, http://www.pacer.gov. 1980–2010 data are from the American Bankruptcy Institute, http://www.abiworld.org; 2011 data are based on cases recorded at http://www.pacer.gov. For statistics covering up to April 2012, see Spiotto (2012). According to the 2007 U.S. Census, there are 89,476 local

governments, which include those that are prohibited by state law from filing under Chapter 9.

15. See figure 8.2. Special Purpose Districts are independent governmental units that exist separately from general purpose local governments such as county and municipal governments for a specified purpose such as airports, cemeteries, conservation, electric power, fire protection, gas utility, highways, hospitals, irrigation, libraries, mass transit, parking facilities, parks, sewerage, solid waste, stadiums, water ports, and water supply.
16. Data for 1980–2010 are from the American Bankruptcy Institute; data for 2011 are based on cases recorded at http://www.pacer.gov.
17. United States Courts, http://www.uscourts.gov.
18. "Muni Threat: Cities Weigh Chapter 9; *Wall Street Journal*, February 18, 2010. See McConnell and Picker, "When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy", *University of Chicago Law Review* 60(2)(Spring): 425–95 (1993). A general purpose municipality is an administrative subdivision governing general municipal functions, as opposed to a special-purpose district which has a defined and limited purpose.
19. "Municipal Bankruptcy in Perspective, A Joint Report from the Bureau of Governmental Research and the Public Affairs Research Council of Louisiana," April 2006.
20. In 1988, a study by Enhance Reinsurance Co. looked at historical patterns of municipal defaults from the 1800s to the 1980s and concluded that municipal defaults usually follow downswings in business cycles and are also more likely to occur in high-growth areas that borrow heavily. Following the 1873 Depression, when more than 24 percent of the outstanding municipal debt was in default, the greatest number of defaults occurred in the South, the fastest growing region at the time. Factors that caused defaults included fluctuating regional land values, commodity booms and busts, cost overruns and financial mismanagement, unrealistic projections of the future, and private-purpose borrowing. The report also said that since World War II, revenue bonds have been a new source of default, largely because actual revenues were less than projected revenues.
21. For example, Orange County, California, which at the time of its Chapter 9 filing was the largest municipal bankruptcy in U.S. history.
22. "Alabama County Brainstorms," *Wall Street Journal*, July 2, 2010.
23. U.S. Constitution Article 1, 8, 10.
24. State programs that deal with municipalities experiencing financial distress, while having many tools to affect municipal financial affairs, may not impair the outstanding obligations to creditors without a substantial governmental interest (for a review of state programs dealing with financially distressed municipalities, see chapter 14 by Liu, Tian, and Wallis in this volume). The Supreme Court laid out a three-part test for whether a law violates the Contracts Clause in Energy Reserves Group v. Kansas Power & Light 459 U.S. 400

(1983). First, the state regulation must substantially impair a contractual relationship. Second, the State "must have a significant and legitimate purpose behind the regulation, such as the remedying of a broad and general social or economic problem." 459 U.S. at 411–13. Third, the law must be reasonable and appropriate for its intended purpose. Only once has the alteration of a municipal bond contract been sustained by the Supreme Court. In Faitoute Co. v. Asbury Park, 316 U.S. 502 (1942), the Court sustained a New Jersey statute authorizing state control over insolvent municipalities. The plan involved an exchange of securities for new bonds with an extended maturity and a lower interest rate. In response to this decision, however, Congress amended the bankruptcy law to proscribe state laws addressing composition of indebtedness from becoming binding on nonconsenting creditors. See 11 U.S.C. § 903. Allowing each state to enact its own version of Chapter 9 of the Bankruptcy Code would frustrate the constitutional mandate of uniform bankruptcy laws. See H. Rept. 686, 94th Cong., 2d Sess. 19, *reprinted in* 1976 U.S. CODE CONG. & ADM. NEWS 539, 557.

25. Section 904 of the Bankruptcy Code provides that absent the consent of the municipality, the bankruptcy court may not interfere with (a) any political or government power of the municipality, (b) any property or revenue of the municipality, or (c) any income-producing property of the municipality.
26. For a thorough discussion of such limitations see David L. Dubrow, "Chapter 9 of the Bankruptcy Code: A Viable Option For Municipalities in Fiscal Crisis?," 24 *The Urban Lawyer* 3, 548 (Summer 1992), p. 552.
27. "The levying of taxes is not a judicial act … it is an act of sovereignty to be performed only by the legislature," Merriweather, 102 U.S. at 515.
28. The functions of the bankruptcy court in Chapter 9 cases are generally limited to approving the petition (if the debtor is eligible), confirming a plan of debt adjustment, and ensuring implementation of the plan.
29. 11 U.S.C. § 109(c).
30. It is a result of such Tenth Amendment considerations that a Chapter 9 filing of an insolvent municipality may only be accomplished as a "voluntary" act of the municipality, and, unlike private entities, a municipality's creditors may not force it into a Chapter 9 filing. In the 2011 Chapter 9 filing by Central Falls, Rhode Island, a provision of a recent Rhode Island law providing that bondholders are to be paid first (limiting the bankruptcy court's authority) became a contentious issue with other creditors such as pension funds and labor unions. See "Pensions Chopped but Investors Paid," *Wall Street Journal*, December 20, 2011, p. C1.
31. Unlike the traditional individual, corporate, or partnership debtor that has a largely unfettered right to choose from a variety of chapters of the Bankruptcy Code (that is, chapters 7, 11, and 13).
32. Id.
33. Id.

34. As defined in 11 U.S.C. § 101(32)(C).
35. 11 U.S.C. § 109(c).
36. Frederick Tung, *After Orange County: Reforming California Municipal Bankruptcy Law*, 53 HASTINGS L.J. 885, 907 (2002).
37. 11 U.S.C. § 101(40).
38. 11 U.S.C. Sec 101 (4). A state is not a municipality for purposes of Chapter 9.
39. In re County of Orange; Orange County Investment Pools, 183 B.R. 605 (Bankr. Ct. C.D. Cal. 1995). On May 10, 2010, Ambac appealed the decision.
40. Created under the nonprofit corporation law of the state of Nevada.
41. Ambac's liability for such bonds was estimated to be US$1.16 billion; Reuters, January 14, 2010. Ambac believed its position as a creditor would be stronger in a proceeding pursuant to Chapter 9 rather than Chapter 11.
42. Municipalities as defined in Chapter 9 are ineligible from filing under Chapter 11.
43. Decision of the District of Nevada Bankruptcy Court, April 27, 2010.
44. Id.
45. In addition, *instrumentality* will be determined by each state's laws and can produce varying results.
46. In re New York Off-Track Betting Corp. (NYC OTB). March 22, 2010, the Bankruptcy Court for the Southern District of New York.
47. 11 U.S.C. § 109(c).
48. See Tung, *supra* note 36.
49. The argument is that allowing one municipality to file signals that the state will not bail out other municipalities if they get into financial distress, and this in turn raises municipal borrowing costs within the state. Michelle J. White, "Sovereigns in Distress: Do They Need Bankruptcy?", *Brookings Papers on Economic Activity*, I: 2002. In addition, the rating of the state could be negatively impacted, as illustrated in the case of Bridgeport, Connecticut.
50. California Government Code S. 53760 (1995).
51. For example, in Connecticut, the Governor must approve a Chapter 9 filing. In Louisiana, a Chapter 9 filing must have the prior consent of the Governor, the Attorney General, and the State Bond Commission. Pennsylvania liberally grants authorization to file Chapter 9, but the effect of filing Chapter 9 automatically triggers the appointment of a state plan coordinator and subjects the municipality to state procedures that act concurrently with federal bankruptcy law. 53 P.S. 11701.261-1170.263 (1995).
52. Source: See note 53. Twenty-two states are silent on the issue, and this silence cannot meet the requirement of "specifically authorize." Georgia specifically prohibits the Chapter 9 filings. In these states, a Chapter 9 filing needs special legislation to be authorized.
53. While the table is based on Laughlin (2005) and Spiotto (2008), we incorporate the new development in which Rhode Island adopted a new law, An Act Relating to Cities and Towns-Providing Financial Stability, on June 11, 2010,

which gives the state-appointed receiver the authority to file under Chapter 9. It is worth noting that the issue of state authorization is changing rather than static. The information, accurate as of August 2010, is subject to rapid change. California, for example, recently modified the procedure of its Chapter 9 filing. For recent development in states' authorization, see Spiotto (2012).

54. As defined in 11 U.S.C. § 101(32)(C).
55. Id.
56. In re City Of Bridgeport, 129 B.R. 332, 335 (Bankr. D. Conn. 1991). The court found that the city had access to a US$27 million bond fund and cited this as an additional reason for not meeting the "insolvency" test. See Rachael E. Schwarz, "This Way To Egress: Should Chapter 9 Filing Have Been Dismissed?," 66 *American Bankruptcy Law Journal* 103 (1992); Dorothy A. Brown, "Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty," 11 *Bankruptcy Developments Law Journal* 626 (1994–95).
57. 11 U.S.C. Sec. 901.
58. The stay prohibits a creditor from bringing a mandamus action against an officer of a municipality on account of a prepetition debt. It also prohibits a creditor from bringing an action against an inhabitant of the debtor to enforce a lien on or arising out of taxes or assessments owed to the debtor. Additional automatic stay provisions are applicable in Chapter 9 that prohibit actions against officers and inhabitants of the debtor if the action seeks to enforce a claim against the debtor. 11 U.S.C. § 922(a).
59. Many municipalities have separate enterprises that are owned or operated by the municipality but are not separate legal entities. Such systems are typically treated as separate accounting units and are paid in the form of fees and charges for services. Such systems are typically financed by debt obligations payable from the system revenue, and in many cases this is the sole source of payment. Such revenues are treated as "special revenues." Special revenues are defined in Section 902(c) as (a) receipts derived from projects or systems primarily used for transportation, utility, or other services; (b) special excise taxes imposed on particular activities or transactions; (c) incremental tax receipts in a tax increment financing; (d) other revenues or receipts derived from particular functions of the debtor; and (e) taxes specifically levied to finance projects or systems (excludes general property, sales, or income taxes levied to finance the general purposes of the debtor.
60. Section 922(d) of title 11 limits the applicability of the stay.
61. 11 U.S.C. § 928.
62. Bondholders have been recognized as having the right to receive those revenues and to block diversion of those revenues to other purposes including general obligation bonds. *Matter of Sanitary and Improvement District No. 7,* 98 Bankr 970, 974 (D Neb 1989).
63. Or at a later time agreed to by the court.
64. 11 U.S.C. § 941.

65. Contracts that are yet to be performed.
66. 11 U.S.C. § 365.
67. Sections 1113 and 1114 of Chapter 11 restricting the ability to reject collective bargaining agreements and to restructure pension obligations do not apply to Chapter 9.
68. In re City of Vallejo, 403 B.R. 72 (51 Bankr. Ct. Dec 2009).
69. See 11 U.S.C. §1126.
70. Often referred to as *cramdown*, 11 U.S.C. 901 (a).
71. See McConnell, *supra,* note 11.
72. The U.S. Supreme Court upheld the constitutionality of Chapter 9's debt adjustment authority in U.S. v. Bekins, 304 U.S. 27 (1938).
73. 11 U.S.C. 941 (b).
74. See below for a discussion of how the feasibility of Vallejo's plan changed due to increasing deterioration of its financial condition during the two-year period it has been in Chapter 9 bankruptcy.
75. In an early irrigation district case, the Ninth Circuit Court of Appeals required a showing that the taxing power was inadequate to raise taxes to pay debt. See *Fano v. Newport Heights Irrigation District*, 114 F2nd 563 (9th Cir. 1940).
76. In addition, increased rates can dampen economic activity.
77. *Supra*, note 31.
78. Sections 903 and 904 of the Bankruptcy Code.
79. 11 U.S.C. § 903 states that "chapter [9] does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of the municipality."
80. Specified in 11 U.S.C. § 926(a).
81. Moreover, a Chapter 9 debtor may employ professionals without court approval, and the only court review of fees is in the context of plan confirmation, when the court determines the reasonableness of the fees.
82. The restrictions imposed by 11 U.S.C. § 904 are necessary to ensure the constitutionality of Chapter 9 and to avoid the possibility that the court might substitute its control over the political or governmental affairs or property of the debtor for that of the state and the elected officials of the municipality.
83. Authors' estimation based on "Bankruptcy Basics" (2006) by the Administrative Office of the United States Courts and the American Bankruptcy Institute; and http://www.pacer.gov. The U.S. Congress amended Chapter 9 in 1937, and the amended law was upheld by the Supreme Court in 1938.
84. United States Courts, http://www.uscourts.gov. For statistics covering up to April 2012, see Spiotto (2012).
85. See Spiotto, James E. (2008) "Chapter 9: "The Last Resort for Financially Distressed Municipalities," in *Handbook of Municipal Bonds*, ed. by Sylvan G. Feldstein and Frank J. Fabozzi. Since 1980, 49 of the 265 Chapter 9 filings have been traditional local governments, towns, cities, villages, and counties (Spiotto 2012).

86. Id.
87. See cases recorded at http://www.pacer.gov.
88. See Spiotto 2008.
89. The authors collected 217 Chapter 9 filings recorded at http://www.pacer.gov, which cover the period starting from 1981. Forty-two filings are by general purpose municipalities. Some filings may be missing since some filings may not be recorded in PACER, and some recorded filings do not give information on the filer. The population data are from the 2000 U.S. Census. We counted those entities that filed twice only once to calculate the median population.
90. Id. See cases recorded at http://www.pacer.gov. The 42 Chapter 9 filings of general purpose municipalities comprise 37 entities and 5 entities that filed twice. These 5 entities include (a) City of Macks Creek, Missouri, filed in 1998 and 2000; (b) City of Prichard, Alabama, filed in 1999 and 2009; (c) City of Westminster, Texas, filed in 2001 and 2004; (d) Town of Moffett, Oklahoma, filed in 2006 and 2009; and (e) Village of Washington Park, Illinois, filed in 2004 and 2009.
91. *Supra,* note 89. See cases recorded at http://www.pacer.gov.
92. A petition for Chapter 9 protection was filed on December 6, 1994.
93. The rest of this section draws mainly from Baldassare (1998).
94. The California Constitution limits local and city control over most tax and many fee revenue sources. Proposition 13 sets property tax rates and caps on the annual growth of parcel assessed valuations. Sales tax rates are also controlled by the state Bradley-Burns Act, with the exception that the local electorate can vote to self-assess at a greater rate for specific or general programs. Fees, assessments, and any new or increased taxes are subject to the constraints of Proposition 218. Fees can be assessed and used only to recover the actual cost of service, and assessments and taxes require property owner approval, voter approval, or both.
95. See Baldassare 1998.
96. See Baldassare 1998, p. 4. The county sued a dozen or more securities companies, advisors, and accountants. Merrill Lynch settled with Orange County, California, for US$400 million to settle accusations that it sold inappropriate and risky investments to Orange County. The county lost US$1.69 billion. The county was able to recover about US$600 million in total, including the US$400 million from Merrill Lynch.
97. The plan provided for the refinancing of outstanding debt, forbearance by the investor local public agencies, and diversion of certain revenue sources to secure the refinancing debt. The impact on the county budget was not a result of the Plan of Adjustment; rather, the impact was felt after Orange County exited from bankruptcy with a substantial debt burden and fewer revenue sources available for the budget.
98. Thirty-one cities, regional transportation agencies, local school districts, local water agencies, sanitation districts, and many small local agencies. See Baldassare (1998), p. 9.

99. See Baldassare (1998), p. 131.
100. Id. p. 179. The social program cuts included (a) a 50 percent reduction in child abuse prevention programs, (b) elimination of a program for the homeless, and (c) closure of a prenatal clinic and 15 clinics for children. The basic infrastructure cuts included cuts in funds for beaches, flood control, harbors, parks, and redevelopment projects.
101. http://www.PennLive.com, May 16, 2010, interview with Chris Street, Treasurer of Orange County, California.
102. White, *supra,* note 49. Orange County raised funds for the plan by laying off workers, selling some assets and cutting expenditures, and issuing new bonds. It attempted to raise its local sales tax, but voters rejected the proposed increase. See "Orange County Adopts Plans To Get Out of Bankruptcy," *New York Times*, December 22, 1995, p. D2.
103. "In the Orange County financial crisis, the bankruptcy forum appears to have provided an appropriate and efficient judicial mechanism for its resolution. The County *qua* municipality remained in control of its 'political' affairs, that is, the operation of government and the provision of public services, while the County *qua* debtor was free to pursue both litigation and negotiated settlement with its creditors. The uniquely binding effect of a Chapter 9, federally confirmed reorganization plan coupled with the inherent limitations creditors face in dealing with a municipal debtor may promote consensus towards an achievable composition of debt." See Jeweler, *supra* note 7.
104. For the years preceding 2008, the City of Vallejo had difficulty balancing its contractual commitments in its General Fund with its General Fund revenues. For fiscal years 2005–06, 2006–07, and 2007–08, General Fund expenditures exceeded revenues by US$3 million to US$4 million per year, resulting in a reduction of General Fund reserves. At the time of the bankruptcy filing, projections were that the city's General Fund reserves would be depleted by June 30, 2008 and that in fiscal year 2008–09, General Fund expenses could exceed General Fund revenues by US$16 million, meaning that the city could not meet its obligations and was technically insolvent. The city was unable to reach agreements with its primary creditors (employee labor associations) that would ensure ongoing General Fund solvency. See official website http://www.ci.vallejo.ca.us/GovSite/default.asp?serviceID1=712&Frame=L1.
105. "For Vallejo, Bankruptcy isn't exactly a fresh start," *The Bay Citizen*, January 23, 2011.
106. "Tough Budget Arithmetic Puts Vallejo in Bind," *Wall Street Journal*, July 15, 2010. http://www.ci.vallejo.ca.us/GovSite/default.asp?serviceID1=712&Frame=L1.
107. In re City of Vallejo, 403 B.R. 72 (51 Bankr. Ct. Dec 2009).
108. The agreements saved the city over US$6 million in General Funds through June 30, 2010. After attempts to facilitate an agreement between the city and the International Brotherhood of Electrical Workers failed, the United States

Bankruptcy Court upheld the city's motion to reject their labor contract. http://www.ci.vallejo.ca.us/GovSite/default.asp?serviceID1=712&Frame=L1. Much of the savings in the renegotiated union contracts come from severe workforce reductions: the police department is down to 90 sworn officers from 155 in 2003, and the fire department was slashed from 122 people and 8 firehouses to 70 people and 5 firehouses. See "For Vallejo, Bankruptcy isn't exactly a fresh start," *The Bay Citizen*, January 23, 2011.

109. *Wall Street Journal*, July 15, 2010. "As Vallejo slogs through its third year of bankruptcy, city officials are giving police a blunt choice; forgo a pay raise agreed to in January 2009" (agreed to in bankruptcy eight months after they filed for bankruptcy protection in May 2008).
110. Id. "What was feasible in January 2009 does not seem feasible 18 months later."
111. Pension plans for retirees and current city employees, including one that allows police officers to retire at 50 with as much as 90 percent of their pay, remain untouched. The city chose not to test whether the attempt to change the existing pensions would be allowed even in bankruptcy, and so remains responsible for some US$195 million in unfinanced pension liabilities. "For Vallejo, Bankruptcy isn't exactly a fresh start," *The Bay Citizen*, January 23, 2011.
112. http://www.huffingtonpost.com/2011/11/02/vallejo-bankruptcy-ends-after-three-years_n_1072;usactionnews.com/2011/01/Vallejo-bankruptcy-plan-offers-unsecured-creditors-5-20jpm.
113. blog.al.com/birmingham-news-stories/2011/11/jefferson_county_among_several.html.
114. May 25, 2008, www.cbs13.com news report, "Vallejo Facing Uncertain Road After Bankruptcy."
115. 665,000 residents.
116. http://www.al.com, published Monday, September 27, 2010. The county entered a consent decree in 1996, agreeing to fix the sewer system after the Cahaba River Society and individuals successfully sued in federal court to show that the county was illegally polluting area creeks and rivers with untreated waste.
117. www.CNNMoney.com May 28, 2010.
118. Shelley Sigo, "JeffCo Has 1st Missed Payment; Defaults on $46 million of Accelerated Principal," *The Bond Buyer*, July 9, 2009, at 1.
119. "Largest Municipal Bankruptcy Filed," *Wall Street Journal*, November 10, 2011.
120. www.articles.businessinsider.com/2011-10-23/wall-street/30312613_1_jefferson-county-sewer.
121. "The Chapter 9 Filing Would Be for All of Jefferson County, Not Just the Sewer System." www.al.com, published Monday, September 27, 2010.
122. Pursuant to which the creditors will not pursue legal remedies during negotiations.
123. JPMorgan bankers were among the financial advisers who persuaded county officials in 2002 to replace traditional fixed-rate bonds with notes having

floating interest rates, including auction-rate securities whose terms are set through periodic bidding.

124. "Largest U.S. Municipal Bankruptcy Looms in Alabama," Joe Mysak, http://www.Bloomberg.com, April 11, 2010.
125. "Alabama County Brainstorms," *Wall Street Journal*, July 2, 2010.
126. According to attorney Jeffrey Cohen, "Raising the rates [that] are already the second or third highest in the country will scare away new business. The businesses that can leave, will leave and frankly the people who are going to have the biggest burden are the homeowners." www.al.com, published, Monday, September 27, 2010.
127. http://www.CNNMoney.com, May 28, 2010.
128. Assured Guaranty, guarantor of the defaulted bonds.
129. "Harrisburg Seeks 'Least Worst' Path," *Wall Street Journal*, April 28, 2010.
130. http://www.CNNMoney.com, May 28, 2010; http://www.PennLive.com, May 16, 2010.
131. "Harrisburg Bankruptcy Filing Voided," *Wall Street Journal*, November 25, 2011.
132. "Judge Rejects Harrisburg Bankruptcy Move," *Wall Street Journal*, November 25, 2011.
133. www.PennLive.com, May 19, 2010.
134. Id.
135. Comments of Westfall Attorney J. Gregg Miller, www.PennLive.com, May 19, 2010.
136. *Financial Distress and Municipal Bankruptcy: The Case of Prichard Alabama*, by Douglas J. Watson, et al., July 1, 2005.
137. *The Deal Magazine*, March 19, 2010.
138. This ruling has no impact on Chapter 9 itself and would be limited to the requirements for municipalities in Alabama to use Chapter 9.
139. And almost never used by large cities such as New York, Cleveland, and Detroit. Large cities have persuaded their states to intervene and provide financial relief. The states of New York and Ohio were heavily involved in their cities' resolution of financial distress, and Michigan has shown no hesitation in its assistance to Detroit.
140. *Supra*, note 11.
141. See State Authorization above.
142. In the case of Bridgeport, the mayor who filed for Chapter 9 lost reelection, defeated by the new mayor whose position was against the filing, *supra,* note 57.
143. See chapter 14 by Liu, Tian, and Wallis in this volume.
144. For example, like Vallejo, Los Angeles is suffering from weak revenue at the same time that the cost of its pensions and other retirement benefits are rising. Former mayor Richard Riordan has said, "The threat of bankruptcy is really the only way you're going to get them to make major changes." Former mayor Richard Riordan said those factors put the government of the second-largest

U.S. city on track to declare bankruptcy between now and 2014. Riordan sees bankruptcy as a necessary tactic for squeezing concessions from the city's public employee unions. It could also pave the way for 401(k) retirement accounts for new city workers instead of defined pension benefit plans with escalating costs, he said. http://articles.latimes.com/2010/may/08/opinion/la-oe-morrison-20100508, May 8, 2010.

145. See *supra*, note 19, "Municipal Bankruptcy in Perspective," A Joint Report from the Bureau of Governmental Research and the Public Affairs Research Council of Louisiana, April 2006.
146. Raphael, Richard J., Friedland, Eric, Laskey, Amy R., and Doppelt, Amy S. "The Perils of Considering Municipal Bankruptcy." Fitch Ratings, Public Finance, January 27, 2010, indicating even the discussion of the possibility of filing is a negative credit factor.
147. Mark Baldassare, president and CEO of the Public Policy Institute of California and author of *When Government Fails: The Orange County Bankruptcy*, University of California Press, Berkeley, CA, a joint publication with the Public Policy Institute of California.
148. www.Ohiohistorycentral.org.
149. *Supra*, note 95.
150. For example, within seven years of Orange County's Chapter 9 bankruptcy, its bond rating has improved from junk status to "Aaa"—the highest rating offered by Moody's Investor Services.
151. Fitch Ratings.
152. *Supra*, note 111.
153. Wes Johnson, "Should Mack's Creek Exist?", *Springfield News Leader*, October 16, 2004 at 1A.; and data from the federal judiciary's case management files (http://www.pacer.gov).
154. For a review of state intervention, see chapter 14 by Liu, Tian, and Wallis in this volume.
155. See Liu and Waibel 2010.

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When Subnational Debt Issuers Default: The Case of the Washington Public Power Supply System

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Introduction

The Washington Public Power Supply System (WPPSS) was the largest municipal bond default in United States modern history. WPPSS was a municipal corporation of the state of Washington. It expanded rapidly in the 1970s since power demand in the region was expected to keep doubling every 10 years, as it had in the recent past. By the end of the 1970s, it had become the largest issuer of municipal revenue bonds in the United States. In the summer of 1983, after years of deepening problems, WPPSS defaulted on US$2.25 billion in outstanding bonds. Without recovery of the US$2.25 billion debt principal, bondholders also stood to lose the US$5 billion in interest owed over the lifetime of the bonds. Of five WPPSS nuclear plant projects for which over US$8 billion was borrowed, only one eventually became operational but generated only a fraction of the revenues needed to repay bondholders.

Municipal defaults since the 1950s in the United States have been very rare (for example, average credit loss rates on Moody's-rated municipal bonds have been extremely low). The 1-, 5-, and 10-year cumulative default rates for all Moody's-rated municipal bond issuers have been 0.0043, 0.0233, and 0.0420 percent, respectively, compared to 0.0000, 0.1237, and 0.6750 percent for triple-A-rated corporate bonds during 1970–2000 (Moody's 2002).

The WPPSS debacle has been well documented over the years, beginning with a series of consulting studies commissioned by WPPSS itself and including hundreds of credit reports by Wall Street firms, analysis by academicians and journalists, and an extensive investigation by the United States Securities and Exchange Commission (SEC). All of this information allows the WPPSS story to serve as a useful case study of what happens in the United States when a subnational government entity defaults on municipal bond obligations. The story provides particularly valuable lessons for governments in emerging markets undertaking efforts to accelerate subnational capital market development.

This chapter is organized as follows. Section two describes how WPPSS went into default, section three discusses major factors contributing to the default, section four asks why WPPSS was not bailed out by either the federal or state government, section five discusses the regulatory reforms in the aftermath of the default, and section six draws lessons that may be relevant for developing countries.

WPPSS: From Creation to Default

The Public Authority Concept

WPPSS was created as a public authority or municipal corporation of Washington State, located in the northwestern corner of the United States. Public authorities are a widely used form of American government. These entities build and run bridges, tunnels, parkways, dams, ports, airports, public buildings, railroads, and industrial and recreational parks.[2] They provide essential services, including water, gas, electric power, and transportation. By the late 1970s, at least 6,000 local or regional public authorities and 1,000 state and interstate public authorities were in operation in the United States (Walsh and Mammen 1983).

Public authorities such as WPPSS are authorized by legislative action to function outside of the regular executive structure of state or municipal government.[3] They are independent legal entities with purposes and powers defined in a statute or charter granted under law. They generally do not have the power to tax, but because of their legal identity they can borrow and own assets. They also can sue or be sued, enter into contracts in their own names, and have liability distinct from that of the government entities that chartered them. Public authorities are designed to have the independence and flexibility needed for them to function as business entities.

This separate legal nature provides two kinds of flexibility, both of which were enjoyed by WPPSS. First, authorities are usually permitted a great deal of administrative flexibility by being exempted from many of the procedures and regulations that apply to executive line agencies, including civil service and personnel rules, procurement procedures, and internal operating rules. Second, public authorities are capable of independent borrowing. In many states, constitutions or legislatures have instituted strict limits on the amount of general obligation debt the state can issue (such debt is backed primarily by the taxing powers of the state). Many states and local governments also require popular referendums in advance of state borrowing and prohibit executive line agencies from selling revenue bonds. The revenue bonds secured by the revenue of a project issued by a public authority are typically not subject to state or local government debt limitations of these kinds.[4]

Public authorities, however, typically operate within regulatory frameworks that combine rules set by the federal government, state, or other "parent" governments, bondholders, and financial accounting and reporting associations. Regulation usually includes the following (Liu 2010): federal government regulations require that borrowing in the municipal bond market must be for a public (not private) purpose and must finance capital projects related to the stated purpose of the public authority. Parent governments often require that borrowings be repayable from a special fund, such as a fund into which revenues of a water system or special tax are deposited. This helps avoid the diversion of revenues to the general budget or commingling in such manner that the funds lose their separate identity. Bondholders usually require that operating revenue be maintained at levels that reflect specific ratios of debt service, and levels of rates/tariffs for services may be required to maintain such ratios (in agreements with bondholders, these kinds of tariff requirements are referred to as rate covenants). Bondholders may also require compliance with historical and projected debt service coverage ratios as a condition for the issuance of additional debt. Accounting standards require adherence to generally accepted accounting principles for government entities, and the regular public disclosure of independently audited financial statements. Legal opinions need to be obtained to confirm that each municipal bond issue is fully compliant with applicable government regulations.

WPPSS was created under Washington state law as a "joint action agency," a type of public authority that enjoyed all of the aforementioned administrative and financial flexibility, but was also subject to few oversight powers from the state. Based on state legislation enacted in 1953, any two or more public utility districts or municipalities were allowed to form a municipal corporation for the purposes of purchasing, building, owning, and operating electrical generation and transmission facilities. Washington was only the second state to pass such legislation (California was the first in 1949), and it was not until 1972 that more states followed suit.

WPPSS faced minimal reporting and auditing requirements—because it was a municipal corporation, its board was required to appoint an independent financial auditor whose report was to be filed with the state auditor. Also, approval for the initiation of certain projects required permits, licenses, and approval from state agencies. But any kind of ongoing, institutionalized oversight activities by the state legislature were essentially nonexistent.

It would be inaccurate to suggest that many more controls would have been available to legislators had WPPSS not been a joint action agency. Municipal corporations in Washington State, like public authorities in most other states, had control over their management and operations. But it appears that because WPPSS, as a joint action agency, was an offspring of the highly respected Washington State Public Utility Districts (PUDs),[5] state legislators considered WPPSS and its problems to be the responsibility of WPPSS and its members. The state legislature finally began to take notice of WPPSS problems in the late 1970s, but by the time an investigation by state officials was concluded in 1981, it was already too late to head off the WPPSS default.

Background to Default

WPPSS was formed in 1957 as a supply arm of its original owner/members—19 PUDs and four cities. All of these members were represented on the WPPSS board of directors, which made all key business decisions for the organization. To build the nuclear power plants WPPSS recruited dozens of project "participants" in several Pacific Northwest states, including municipal utilities, other PUDs, irrigation districts, and rural electric cooperatives. The participants agreed to buy the generating capacity of the WPPSS nuclear plants. But the nuclear plants represented a massive increase in the size and complexity of WPPSS projects.

For the first 14 years of its existence—from 1957 to 1971—WPPSS constructed and operated only two small power projects with a combined operating capacity of 890 megawatts. In 1971, WPPSS began work on the first of five nuclear power plants, because power demand in the region was expected to keep doubling every 10 years as it had in the recent past. The first three plants received backing from the Bonneville Power Administration (BPA), a federal agency still active in the region, which markets and transmits power generated at federal hydroelectric projects in the region. The backing took the form of a "net billing" arrangement whereby BPA undertook to purchase all of the power from the three plants of WPPSS, then sell it to its customers, including over 130 utilities and industrial customers in the region, far more than the WPPSS members or project participants. If individual BPA customers could not or would not pay, the cost would be shared across the rest of BPA's customer base. The arrangement meant that a federal agency was the principal offtaker of power and that the bonds sold to finance the first three plants were considered low-risk investments by rating agencies and bond investors, many of whom assumed that the BPA role constituted a federal guarantee of debt service payment. What many investors did not understand was that BPA was not authorized to access federal treasury funds or borrow on its own account to make good on such commitments.

By 1972, BPA planning had determined that even more power-generating capacity would be needed by the early 1980s. The agency encouraged WPPSS to undertake construction of two more nuclear power plants to meet regional power needs, and it was the eventual failure to pay interest on the bonds issued to pay for these additional two plants that triggered the default in 1983. By the time borrowing was needed for these two new plants, BPA was no longer able to use the net billing arrangement to back WPPSS borrowing because of changes in federal regulations. To provide the security necessary to attract investors to the new bond issues needed to finance the new plants, WPPSS signed "take-or-pay" contracts with 88 project participants, mostly municipal and regional utilities, which obligated these participants to pay their shares of project costs, including debt service on the bonds, whether or not Projects 4 and 5 were ever completed or capable of generating power.

At the time, the investment community had great faith in take-or-pay contracts, which had long been used in electric revenue bond financing. Most experts believed that bonds could not be sold for nuclear power projects without take-or-pay backing, or some other method almost as secure, due to the substantial risks of construction delay. The take-or-pay contracts put the project and construction risks on the members. At the time of the WPPSS default, over a dozen joint action agencies across the country were financing major power project construction using take-or-pay that were virtually identical to the ones used by WPPSS—in several cases state supreme courts had already upheld their use (Tamietti 1984). Because participating utilities were not subject to regulation by federal or state utility commissions, they had unlimited authority to set rates for existing customers. In theory this meant that they were capable of complying with the take-or-pay contract provisions by raising rates as high as necessary on existing customers to pay off the WPPSS debt even if the nuclear plants were not completed and no new customers could be added to their systems. The take-or-pay contracts were almost as helpful as the BPA net-billing arrangements in convincing rating agencies, underwriters, and investors that WPPSS bonds were highly secure investments. WPPSS therefore had no trouble borrowing from the securities markets. WPPSS Projects 1, 2, and 3 bonds were rated triple-A by Standard & Poor's and Moody's until January 1983 and Project 4 and 5 bonds were rated A-plus by Standard & Poor's until June 1981.

But by the end of the 1970s, WPPSS was facing serious problems. The 1970s energy crisis dramatically slowed growth in demand for electricity and demonstrated to energy planners that simplistic straight-line demand growth projections were unable to fully capture the potential impacts of energy conservation.[6] At the same time the WPPSS nuclear projects were plagued with construction delays and cost overruns. The plants were initially estimated to cost US$4.1 billion, but by 1981 the estimate had grown to US$23.8 billion. In 1982, WPPSS terminated construction on Projects 4 and 5, acknowledging that the plants would never be completed and never generate the revenues needed to pay back the US$2.25 billion in affected bonds. Pursuant to the take-or-pay contracts, the default signaled that the 88 participating utilities, and ultimately their customers, were obligated to pay back the borrowed money from whatever other sources were available, even if it meant dramatically raising electricity rates to their customers. But the region (and the country) was inflicted by a deep recession in the late 1970s to the early 1980s. In some small northwest towns already affected by unemployment, the cost amounted to more than US$12,000 per customer.

When 28 WPPSS participants (municipalities and PUDs), accounting for two-thirds of the Projects 4 and 5 shares, refused to pay for their share of the projects, a lawsuit was filed by the trustee for the bondholders of the Projects 4 and 5. The Washington State Supreme Court ruled in July 1983 that the utilities had lacked the legal authority to enter into take-or-pay contracts (promise to pay for something that they would not receive, that is, power plant output that might never exist), thus the contracts were void and unenforceable. The legal sources of the judgment included existing statues, constitutional provisions governing the authority of home rule cities, and case law.[7] Prior to this decision, the Washington State Supreme Court had never ruled on the legal issue relating to the legality of take-or-pay contracts. The ruling demonstrates the autonomy of state law and the risks of assuming that the legal decisions of one state can be used to predict the outcomes of court cases in other states. This ruling illustrates that debt obligations and their underlying security arrangements are based on obligations to pay that are lawfully entered into and can be legally enforced.

The 80,000 affected bondholders began a series of legal actions against WPPSS and other major actors in the disaster, charging fraud and misrepresentation in the sale of the bonds.[8] The major lawsuits continued for the next 13 years. In 1988, a settlement was reached for US$753 million. The last settlement was reached in 1995. Of the five plants, only one was completed—one of the three backed by the BPA. Revenues from that plant helped BPA continue to pay debt service on bonds issued for the first three plants, so there never has been a default on any of those BPA-secured bonds.

By August 1989, WPPSS was back in the municipal bond market, issuing US$450 million in bonds to refinance some of the outstanding debt used to finance the two closed plants backed by BPA. Even though the projects were no longer being built, and clearly would never be finished, the refinancing bonds received investment-grade ratings from Moody's and Standard & Poor's because of the BPA support. The remaining structures of the other four plants were demolished in 1995. In 1998, WPPSS renamed itself Energy Northwest and began to focus on wind and solar energy projects. In 2002, 19 years after the default, Energy Northwest once again sold bonds for the construction of a new energy-generating facility and US$70 million was raised for a 48-megawatt wind energy project.

Factors Contributing to the Default

The major contributing factor to the default was the failings of WPPSS management. When the Washington State Senate finally began investigating WPPSS problems in 1981, they concluded that "WPPSS mismanagement has been the most significant cause of cost overruns and schedule delays on the WPPSS projects" (Washington State Senate Energy and Utilities Committee 1981). An administrative auditor engaged by the legislature discovered that 11 substantial management consulting reports incorporating over 400 specific recommendations had been commissioned and received by WPPSS from 1976 to 1980. But most of the recommendations were not implemented. The auditor noted that during the crucial years from 1971 to 1979, "the type of staff required to manage the growing giant of a program was simply 'not in place'" (Washington Public Power Supply System 1980).

The specific management problems are well documented in the consulting studies done during the 1970s (Leigland 1988). At the end of the 1970s, WPPSS was still being managed in many respects as if its size and responsibilities remained at 1971 levels. The huge growth in organizational size, complexity, and responsibility had not been accommodated by management and organizational changes. The size of the WPPSS staff increased from 81 in 1971 to over 550 in 1976, with thousands of construction personnel working on each of the individual projects. Administrative expenses increased from just over US$1 million in 1972 to over US$33 million in 1976. With Projects 4 and 5 fully under construction, it was clear that both administrative costs and the number of personnel would continue to grow rapidly. By 1981, the number of staff personnel had grown to over 2,000, with an additional 14,000 construction personnel working under 400 separate contracts.

WPPSS quite literally grew out of control because its management style did not mature. In the late 1970s, the top management of WPPSS was still exercising a management style appropriate for a small business, characterized by concentration of authority and accountability at the top levels. WPPSS directors tended to be successful small businessmen whose public power management experience was limited to approving budgets for local utilities and promoting local power use. A few were utility managers, but none had experience with large-scale construction, nuclear power, or complex financing. All of these shortcomings of WPPSS governance were documented in the management consulting reports completed during the 1970s, but the findings were apparently never fully appreciated in WPPSS until after a new managing director was recruited from outside the organization for the first time in 1980.

Members of the investment community—Wall Street underwriters, dealers, institutional investors, rating firms, and bond attorneys—also played roles in the WPPSS drama. Both ratepayers and many bondholders argued that the pursuit of short-term profit caused the investment community to lose sight of the true investment quality of the WPPSS bonds.

Credit analysis—the assessment of the ability and willingness of a debt issuer to pay back those debts in a timely fashion—is considered by nearly all the members of the investment community to be an important foundation of the work that they do. However, the WPPSS debacle caught Wall Street by surprise. Credit analyses prepared by major Wall Street firms routinely misunderstood key legal and economic factors affecting WPPSS (see Leigland and Lamb 1986). Authors of credit reports took for granted the opinions of bond attorneys who assumed the legal validity of take-or-pay contracts without considering how elected state judges might view those contracts under the politically charged conditions of WPPSS project failure. Analysts also failed to correctly estimate the chances of delayed debt service payments (and short-term or technical defaults) resulting from court challenges to those contracts.

Typically, analysts expected that new federal legislation would allow BPA to purchase the output of Projects 4 and 5 (as it had for the first three projects) even after the bill was passed and made such a purchase extremely unlikely. Straight-line growth projections were taken at face value, and the conflicting demand growth studies of other groups or public agencies were almost never mentioned. The many management consulting studies that painted such damning portraits of management incompetence were never mentioned much less examined by most analysts, even though those studies were available to the general public.

Until January 1983, both Standard & Poor's and Moody's gave bonds for WPPSS Projects 1, 2, and 3 triple-A ratings, the firms' highest rating (these were the BPA secured bonds with the quasi-indirect federal guarantee). Roughly US$6 billion bonds were sold with the benefit of that rating. In June 1981, Standard & Poor's lowered its rating for Project 4 and 5 bonds from A-plus to A (these are the bonds secured by the take-or-pay contract later defaulted). Shortly after, Moody's also downgraded these bonds. WPPSS 4 and 5 bonds were never sold again, but US$2.25 billion had been sold with the benefit of Moody's A-1 and Standard & Poor's A-plus ratings. The downgrades came too late to benefit the bond-buying public. By June 1983, Moody's had suspended ratings for all WPPSS project bonds, and Standard & Poor's had suspended ratings for Projects 1, 2, and 3, with Project 4 and 5 bonds given a highly speculative, CC rating.

The financial advice provided to WPPSS was more concerned with marketing of WPPSS bonds than with strengthening creditworthiness. In 1980, the principal problem occupying WPPSS financial advisors[9] was the fact that the portfolios of institutional investors, the largest purchasers of WPPSS bonds, were saturated with those securities. The spaces typically reserved in those portfolios for securities of the type issued by WPPSS were largely filled. By 1980, WPPSS, as the largest issuer of revenue bonds, had been marketing major new long-term bond issues about every six or seven weeks. Other similar kinds of securities were also competing for the same space. WPPSS thus faced the problem of raising an additional US$5.34 billion before 1985. WPPSS proposed that WPPSS tailor its offerings to occupy some new "space" in investor portfolios.[10]

WPPSS underwriters proposed a different strategy for effectively marketing new WPPSS debt, one which WPPSS executives decided to implement (Marion and Quinn 1980). Instead of selling short-term debt, WPPSS was advised to shift from competitive to negotiated underwriting. The number of underwriters competing for WPPSS business was declining. As this happened, bidders were asking for higher remuneration. By switching to noncompetitive negotiated underwriting, WPPSS could establish a relationship with a single underwriter/arranger who would not jeopardize the relationship and future business by trying to maximize current returns on a single bond sale. WPPSS was convinced of the soundness of this approach and launched its negotiated bond program with a US$750 million issue in 1981.

Unfortunately, the negotiated offering procedure did nothing to improve WPPSS underlying creditworthiness. The risks associated with the bonds were clearly increasing and were already apparent to most sophisticated investors. Knowledgeable institutional investors had begun to shy away from WPPSS, so bonds had to be sold in smaller-than-usual lots to attract individuals. The new negotiated underwriter selected by WPPSS used extensive presale surveys and public relations efforts that were successful in appealing to individual investors. Since the underwriter was preparing a WPPSS issue, the underwriter's own research department (a separate unit in the company) issued one of the most thorough critiques of WPPSS bonds prepared to date, citing cost overruns, management inadequacies, and the possibility of plant shutdowns (Sitzer and Karvelis 1981).

No Bailout

After the default, WPPSS bondholders hoped to benefit from a bailout. A series of bailout plans had been proposed including (a) a proposal by WPPSS participants to use a federal subsidized loan to purchase new bonds issued by WPPSS and to use the bond proceeds to pay WPPSS debt service,[11] (b) a regionalization plan by mostly WPPSS participants to spread Project 4 and 5 debt through BPA billings to its regional customers,[12] and (c) a proposal to create a federally chartered regional financing agency to sell bonds to pay off WPPSS debt and finance final construction costs.[13]

But none of the many bailout proposals developed by and for WPPSS were seriously considered by Congress. The tradition of federal unwillingness to become involved in state and local bailouts went back more than a century, with the federal position crystallized in a series of refusals to assume state debts after several state defaults occurred in the mid-19th century (Wallis 2005). The default justification was that the federal government did not want to signal that fiscal irresponsibility would not be penalized by default or bankruptcy, but instead would be rewarded with bailouts paid for by taxpayers. The federal refusal to bail out an entity like WPPSS was also related to the concept of state sovereignty in the U.S. system of federalism—if states were going to jealously protect their right to self-determination from federal interference, including their right to sell tax-exempt bonds, then they should be prepared to handle their own problems without the expectation of extraordinary federal help.

There were also several more practical reasons for the federal position. By the early 1980s, the failings of WPPSS management were well documented and widely believed to be the primary cause of WPPSS problems. Project failure (if not the long-term default itself) did not appear to have been beyond the control of WPPSS management, and therefore special outside assistance was not easily justified. Even among local and regional politicians there was little support for a bailout, perhaps largely because justifying outside assistance would mean admitting that WPPSS was not solely responsible for its own problems.

From 1972 to 1983, over 100 nuclear-power-generating plants were cancelled in the United States, twice the number of coal plants. In 1982 dollars, those plants represented almost US$10 billion in investments. With some nuclear utilities experiencing some problems similar to those of WPPSS, Congress was wary of putting itself in a position of obligation to all by recognizing an obligation to WPPSS.

The WPPSS default lacked an injured party, other than bondholders. No massive unemployment or disruption of crucial municipal services would result from the WPPSS default—the five plants were not yet remotely close to operational. Nor did it appear that the economic interests of the region would be significantly harmed by the default. Various Wall Street executives made vague threats of penalizing Washington State with higher interest rates on new debt because of the state's failure to come to the aid of WPPSS, but knowledgeable observers knew that competitive pressures within the financial community would lead to business as usual when state bonds next came to market, as was indeed the case. The 80,000 affected WPPSS bondholders certainly constituted an injured party. A sample survey of 10,000 WPPSS bondholders conducted in 1985 revealed that two-thirds were over 60 years old, and more than half were retired and seeking a modest supplement to their social security income (Lehmann 1986). The votes of disgruntled bondholders were dispersed across the country, with ratepayers affected by WPPSS focused in two states (Washington and Oregon).

Regulatory Reforms of the Municipal Bond Market in the Aftermath of Default

Participants in the municipal bond market include issuers, bondholders, underwriters, fund managers, bond attorneys, and advisory services. Total municipal debt outstanding at the end of 2011 was US$3.05 trillion.[14] The United States has the largest municipal bond market in the world.

Beginning in the 1960s, the use of revenue bonds began to grow rapidly, accounting for 50 percent of all tax-exempt bonds by 1975 and 83 percent by 1983 (Bond Buyer 1985). These kinds of securities are usually issued by public enterprises or public authorities, and the security behind them is the explicit stream of revenues identified in the bond resolution and offering. Revenue bond repayment usually depends heavily on the contemplated operating revenues of the project to be built—tolls from roads and bridges; mortgage payments from housing developments; or, in the case of WPPSS, revenues from the sale of electricity when and if the plants are completed, fully tested, and operating. With the shift from general obligation bonds to revenue bonds, real credit quality depends on the economic and financial feasibility of the issuer and each individual project rather than on the full faith, credit, and tax base of governments.

Each bond resolution and prospectus designates a trustee, usually a bank, to represent the bondholders over the terms of the bonds for purposes of collecting and distributing interest payments and pursuing legal protection of bondholders' rights. Bond attorneys and financial advisors often devise special arrangements to strengthen the security behind revenue bonds and thereby make them more attractive to the investors to whom the bonds will be sold by underwriters. A syndicate of underwriting firms usually buys the entire bond issue from the public enterprise at a negotiated price or by competitive bid. The members of the syndicate then attempt to sell the bonds to the public at a higher price, and the difference, or spread, supplies profits to the underwriting firms. WPPSS and the utilities participating in its projects, like other public agencies, depend heavily on the advice of a relatively limited number of national bond attorney firms and investment advisory and underwriting firms both to understand their own credit situation and to design the most appropriate security arrangements behind their bond issues. The ultimate buyers of the bonds also depend on the opinions and representations of these firms.

Until the mid-1970s, the municipal bond market was essentially unregulated by the federal government. Although municipal securities are subject to the antifraud provisions of the Securities Act of 1933 and the Securities and Exchange Act of 1934, the two acts exempted municipal securities, and almost all parties associated with the municipal securities market, from most of their regulations affecting corporate underwriting, buying, selling, and trading. Congress was also wary of violating the sovereignty of state governments by imposing federal rules on states or local government borrowers. The municipal market was relatively small at that time and considered free from the problems that plagued the corporate securities market. As a result, the municipal market was run on a self-regulated basis by the issuers themselves and their service providers from the investment community.

The near default of New York City in 1975 prompted Congress to introduce changes in municipal bond regulations.[15] But largely because of the state sovereignty issue, Congress chose not to eliminate the exemption that municipal bonds were granted by the Securities Act of 1933. Instead, Congress compromised by creating an industry self-regulating body known as the Municipal Securities Rulemaking Board (MSRB), made up of members from the investment community and general public. The MSRB was to establish fair practices for underwriting and trading municipal bonds. As part of the system, brokers and dealers had to register with the SEC, but government issuers were not required to follow any pre-issuance or post-issuance filing requirements. The system was based on good-faith voluntary disclosure.

After the WPPSS default in 1983, the SEC noted the many parallels between the New York City crisis and the WPPSS default: offering documents did not disclose key facts about the borrowing, like accurate cost estimates or demand projections; underwriters did not attempt to verify disclosures but instead used the vague or incorrect information to market the bonds; Unit Investment Trusts purchased the bonds on the basis of ratings that were widely known to be unrealistically high; and bond counsel did not fully disclose potential legal problems. The SEC noted that in both the New York City and WPPSS cases "neither the underwriters nor the rating agencies accepted responsibility for reviewing the offering documents" (Ruder 1988).

In 1988, following a five-year investigation, the SEC decided not to propose new legislation or authorize any enforcement action relating to the WPPSS case, citing the "massive private damage litigation" already underway (U.S. Securities and Exchange Commission 1988). The SEC did adopt a new rule requiring underwriters to obtain an offering prospectus from public issuers for bond sales of US$1 million or more, assess the document (known in the municipal market as an Official Statement) in terms of truthfulness and completeness, distribute these documents to potential purchasers, and file them with private entities designated as repositories of municipal securities information. In other words, again the SEC refrained from directly regulating the activities of government issuers, but instead tried to effect this regulation indirectly by creating responsibilities for underwriters. In addition to be being indirect, the content and form of the disclosure document was not specified and therefore not regulated (except that the antifraud provisions of the Security Act did prohibit materially misleading statements, even in municipal offering documents).

In 1994, the SEC turned its attention to secondary market disclosure issues, another problem that had arisen with the WPPSS securities flooding the market in the 1970s and early 1980s. As the problems of WPPSS became known to Wall Street insiders, sophisticated investors looked for ways to sell their holdings in the secondary market, where many investors knew little about the current financial situation of WPPSS, or any other government entity whose securities they were buying. In 1994, the SEC imposed another rule indirectly on government issuers by prohibiting underwriters from handling securities from issuers that did not agree to provide annual reports with updated financial information and timely reports of material events. These reports were to be sent to municipal information repositories, where they would be available to the general public.

The SEC's use of indirect action illustrates the challenges of balancing the need to regulate the subnational debt market and the cost of enforcing regulations. There was criticism of the SEC's indirect securities regulation.[16] The costs to the federal government of closely regulating the municipal market, however, would be exorbitant. It also raises the issue of the federal and state relation.

The dependency on voluntary compliance has not affected the growth of the municipal bond market. From the US$26 billion in new municipal bonds sold in 1975 when WPPSS started planning Projects 4 and 5, the new issue market had grown sixfold by the time the SEC's report on WPPSS was issued in 1989. Today, the new issue market is over US$400 billion, with 50,000 issuers and 40,000 daily transactions. The corporate securities market has twice as much debt outstanding, but only 8,000 issuers (Municipal Securities Rulemaking Board 2012). The default rate in the municipal market remains low.

Lessons Learned

The WPPSS default offers lessons for governments in emerging economies attempting to create subnational bond markets or to accelerate the issuance of such debt for infrastructure investment purposes. The U.S. municipal market is often used as a model for such efforts. It has powerfully attractive features, particularly in terms of its ability to allocate huge amounts of capital for government projects, especially in infrastructure sectors. Three-quarters of this debt is sold to individual investors, either directly or indirectly via mutual funds or other investment vehicles. A municipal bond market is not just another mechanism to intermediate savings to help finance much needed large-scale infrastructure; it is also a way to effectively access the domestic savings of individuals and provide individuals with fixed-income investment returns. Finally, the fact that less than one-quarter of the U.S. municipal market in 2010 involved general obligation debt backed solely by taxing power means that it is possible to back borrowing from the revenues of the facilities to be built with the bond proceeds. Subnational governments can indeed raise money for investment in a commercial manner.

The WPPSS default, a rare default event in terms of scale and frequency in the modern U.S. subnational debt market, offers a window into the interactive roles of the market, the courts, the regulators, the debtor, the creditors, and taxpayers. Even in a developed functioning market like the United States, the issuance of debt for infrastructure has endemic risks that must be dealt with by the legal and regulatory structure. WPPSS illustrates the risks of the lack of transparency and disclosure, the risks of project analysis and feasibility projections, and the risks of poor management and construction delays. These risks exist in all infrastructure projects whether in developed or developing countries. Since debt is a legal obligation to pay, it must be lawfully authorized and enforceable. The role of the legal and regulatory environment is to attempt to minimize such risks and to respond to risks that will be identified from time to time, as has happened over the course of the subnational debt market development in the United States.

The lessons revolve more around the fact that the U.S. municipal market is a unique product of 200 years of experimentation. As shown in chapter 14 in this volume, the U.S. municipal securities market has developed gradually over a long period of time, with gradual and incremental reforms. For short stretches within that time span, for example during the mid-19th century, the market was plagued by defaults and other scandals. The market has had a considerable amount of time to evolve and mature into the mechanism that it is today. Nothing illustrates this better than the fact that the U.S. municipal market showed very little evidence of damage resulting from the WPPSS default. The WPPSS default briefly pushed up municipal bond interest rates, but only slightly. Not only did the market quickly return to normal after the WPPSS default, but the period during which the WPPSS drama unfolded, from 1975 to 1985, was one in which total annual municipal bond issuance grew tenfold—the most dramatic decade of growth in the history of the modern market.

Already by the 1980s, the municipal market had the size and durability to survive a US$2.25 billion default,[17] and also fully take advantage of such a default by benefiting from the sort of disciplinary message sent to market participants that the financial and legal consequences of mismanagement by and poor oversight of municipal borrowers are real. Rescues and bailouts of such borrowers and their bondholders are unlikely under most circumstances in the United States. And even though the SEC took minimal enforcement action against actors in the WPPSS drama, the principle of self-regulation did not mean that these actors could avoid responsibility for their actions. The amount of private damage litigation that followed for years in the wake of the default was unprecedented and resulted in many failed careers and business collapses. Very few individual market participants gained from the WPPSS disaster, but the market more than weathered the storm. It became stronger as a result.

Most developing countries do not have the luxury of benefiting from defaults in quite the same way. The risks of default on new subnational issues, and the resulting risks of long-standing damage to nascent bond market activity, are dangerously high. Many of these economies simply lack experience with debt issuance of any kind. Private companies often raise capital by issuing equity rather than borrowing, because of macroeconomic instability, lax bankruptcy laws, burdensome tax laws, and government policy promoting share ownership. The sovereign debt market may be in an early stage of development. The absence of long-term corporate or treasury debt means that benchmark yield curves are not available for pricing long-term municipal bonds. Investment intermediaries are usually not familiar enough with municipal issuers to be able to distinguish creditworthy borrowers from uncreditworthy borrowers. In such weak market environments, investor confidence in long-term municipal issues tends to be low. Subnational markets in many of these economies are at risk of being shut down by early defaults.

As noted, revenue bonds issued by municipal corporations account for over two-thirds of total subnational debt outstanding in the United States. Outside the debt limitation imposed by state constitutions or legal frameworks, municipal corporations have taken on major responsibilities in infrastructure investments. As developing countries take on infrastructure investments to meet the growth demand, WPPSS offers a lesson in managing infrastructure projects with care and prudent governance and management structure. It is important to highlight that although municipal corporations have borrowing and management flexibility, they are subject to regulatory rules and market discipline. The municipal corporations should not be used as a way of circumventing borrowing rules. While there was no federal or state bailout in the case of the WPPSS default, the desire to bail out in a developing country could be strong, particularly if the project entails significant liabilities and affects a large population.

Policy makers in developing countries need to identify a number of basic ways in which issuers and investors are attracted to the municipal bond marketplace. Many of these policy makers have been innovative in trying to find proxies to achieve the same results, using the key characteristics of the U.S. market as targets to be achieved in some fashion if municipal bond market development is to be facilitated in their countries. For example, careful prescreening of issuers helps to substitute for the ability possessed by many market players in the United States to spot obvious problems with creditworthiness before issuance (see Leigland 1997 for examples of this from Indonesia, Poland, and South Africa).

One lesson of the WPPSS experience is that it is necessary to develop subnational bond markets with care, and that it should not be assumed that features of the U.S. market can simply be transplanted to developing countries. The WPPSS case happened in a country with a developed and sophisticated system of legal jurisprudence, which should serve as a caution to developing environments where the rule of law and legal principles are much less developed and clear. Legal risk is a substantial factor in debt markets. Although the regulatory framework for the U.S. municipal markets cannot be directly replicated in other counties, some of its most important features are generally applicable—creating clear interest among creditors to support strengthening both the rule of law and incentives for private market development, enhancing transparency and disclosure of the credit risks of all issuers, and a no-bailout policy to reduce moral hazard and enforce market discipline on debtors and creditors.

Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

1. This chapter draws mainly from the book *WPP$$: Who is to Blame for the WPP$$ Disaster* by James Leigland and Robert B. Lamb (1986).
2. Public authorities are also called corporations, authorities, agencies, commissions, and so forth.
3. They can also be created by local governments.
4. For a history of revenue bonds and their relation to debt limitation set by states, see chapter 14 by Liu, Tian, and Wallis (2013) in this volume.
5. When direct federal sponsorship of public hydropower development began to taper off in the mid-1950s, the PUDs inherited a highly successful legacy of hydropower expansion and became the focus of regional public power development. In Washington State the PUDs combined the legal autonomy and revenue-debt-issuing capacity of public authorities with the taxing powers of special districts, and had democratically elected boards. But because many of them were small, they considered legislation enabling the formation of joint ventures a necessary part of their role in developing the area's power resources. The desire to help PUDs develop the hydroelectric potential for the region was the motive behind the state law authorizing the creation of joint action agencies. The locally based democratic control over PUDs was to be used to control joint action agencies as well.
6. A study commissioned by the Washington State Legislature predicted in late 1981 a 1.5 percent annual growth rate, much lower than the 7.5 percent that had justified the huge Hydro-Thermal Power Program.
7. For a detailed account of the legal decision and the legal sources for the court decision, including the appeal to the U.S. Supreme Court (which declined to review the Supreme Court rulings without comment), see Leigland and Lamb (1986, 167–77). See chapter 14 by Liu, Tian, and Wallis in this volume for a discussion of these factors in American history more generally.
8. In the case of WPPSS Project 4 and 5 bonds, the trustee (Chemical Bank) in August 1983 initiated the first in a long list of WPPSS-related lawsuits by suing WPPSS, the participating utilities, and the BPA on behalf of the bondholders. The charge was fraud in the sale and subsequent failure to pay interest on the bonds.
9. Blyth Eastman Paine Webber Public Power Finance Group 1980.
10. One way of doing this was to encourage investors to view WPPSS bonds as backed more by hydropower revenues from the first three plants supported by BPA than by revenues from the nuclear power plants (BPA had no legal connection to the bonds sold for the nuclear power plants). A second way was to issue short-term

debt instruments rather than long-term bonds, which entails refinancing risks. See Blyth Eastman Paine Webber Public Power Finance Group 1980.

11. In 1982, American Express Company, at the request of the WPPSS participants, devised this direct federal rescue plan.
12. In March 1983, just prior to the Washington State Supreme Court decision invalidating the take-or-pay contracts, members of the Washington Public Utility Districts Association (most of whom were WPPSS participants) suggested a number of support options. One possibility offered was a regionalization plan, similar to the original BPA net-billing arrangements, which would spread Project 4 and 5 debt through BPA billings to its regional customers, including non-WPPSS participants and other service providers.
13. A special commission appointed by the governor of Washington State recommended the plan.
14. Federal Reserve Board, *Flow of Funds, Accounts of the United States, 2005–2011*, June 7, 2012b, table L.104, p. 63. The term municipal bond market in the United States includes bonds issued by states, cities, special purpose vehicles, and public authorities.
15. At the time, New York City and its corporate entities had US$14 billion in debt outstanding, of which US$6 billion was short-term, requiring constant refinancing. The city also had an operating deficit of over US$2 billion. Underwriters began to resist city efforts to sell more debt, particularly when a New York State public authority, the Urban Development Corporation (UDC), defaulted on its short-term debt. Although separate from the city, most UDC projects involved city housing. When the state legislature moved to pay suppliers and contractors but not bondholders, investors began to question what would happen to city bondholders if the city defaulted, or worse, declared bankruptcy. The state government eventually stepped in and created the Municipal Assistance Corporation as an independent corporate entity of the state empowered to control New York City budgets and financing activities. New York City only narrowly avoided default.
16. See, for example, Seligman 1989.
17. Total state and local government securities outstanding at the end of 1980 were US$337 billion, so the WPPSS bonds account for less than 1 percent of the market (Federal Reserve Board, *Flow of Funds Accounts of the United States, 1975–1984,* June 7, 2012a. Table L.104, p. 63).

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Part 3

Developing Subnational Debt Markets

10

Transition from Direct Central Government Onlending to Subnational Market Access in China

Lili Liu and Baoyun Qiao

Introduction

China has been investing about 10 percent of its gross domestic product (GDP) annually in infrastructure since the 1990s, a much higher rate than in many other developing economies. Under China's decentralized fiscal structure, subnational governments (SNGs)[1] have taken on a large share of infrastructure investments, particularly in urban areas. A substantial part of subnational urban infrastructure investments has been financed by debt instruments. China's large national savings, at about 50 percent of GDP, has made the debt financing feasible.

The legal and institutional frameworks for subnational debt financing in China have undergone significant reforms gradually, in recognition of the fact that institutions, capital markets, and market access take time to develop. The debt instruments have been evolving, from simple to more sophisticated instruments. The development of regulatory and institutional frameworks and of market debt instruments is characterized by learning by doing. The reform is still unfolding.

Prior to 2009, SNGs relied on central government onlending and their own off-budget vehicles—Urban Development and Investment Corporation (UDIC) borrowing directly from the financial markets—to finance infrastructure investments. The UDIC started in the mid-1990s in tandem with significant fiscal decentralization in China, and with the 1994 national taxation reform that delineated the spending and revenue assignments between the national government and SNGs. In addition to debt financing, UDICs have also extensively used land asset-based finance to build urban infrastructure.

The central government's onlending and UDICs' direct borrowing from the financial markets, together with land asset-based financing, have helped transform the urban infrastructure landscape in China, including the rapid development of transportation systems, power systems, and water and sanitation systems. By the mid-2000s, the limitations of these financing instruments had become evident to policy makers.

First, direct central government onlending to SNGs separates the borrowing power (the central government) and the payment obligations (SNGs). When the central government issues the debt and then onlends the proceeds to an SNG, the SNG has no market interaction with creditors, and the market assigns the responsibility to the central government and assumes an explicit guarantee by the central government. Second, UDICs' implicit off-budget debt and liabilities are nontransparent and difficult to monitor. They create contingent liabilities for SNGs and may also implicate the central budget. By 2010, the total subnational debt outstanding in China was estimated at RMB 10.7 trillion, about 27 percent of GDP.[2] More important, information on the subnational debt was asymmetric between the central government and SNGs due to the off-budget practices of UDIC borrowing.[3] Third, financing infrastructure through land lease is not sustainable in the long run, because of its one-time nature.[4]

Since 2009, China has undertaken substantial reforms to address the above challenges. The reforms have consisted of three critical elements: (a) providing a more direct link between borrowing and debt-service responsibility by allowing the issuance of provincial bonds, and later by piloting municipal bonds; (b) conducting a comprehensive audit of UDIC off-budget debt and moving toward greater fiscal transparency by bringing off-budget contingent liability onto the subnational budget; and (c) developing an institutional framework for regulating and managing subnational debt. These reforms have been augmented by other reforms in fiscal management and better management of land asset-based financing.

The 2008–09 global financial crisis provided a broad context, and an opportunity, for the transition toward market access for SNGs. To cushion the impact of the crisis, China implemented a proactive fiscal policy—the key components of which included an RMB 4 trillion economic stimulus package to promote public investments and a tax cut to promote private investment and consumption, such as raising the export tax rebate and reducing the tax burden on businesses and residents. Most of the public investment programs under the stimulus package were to be undertaken by SNGs. The implementation of the fiscal stimulus brought fiscal challenges to the SNGs, because of the projected large financing gap between SNG expenditure and revenue.

There are two ways to close the financing gap through borrowing: the central government can onlend to SNGs, or SNGs can access market financing. A basic problem with onlending is the absence of a link between debt issuance and the responsibility for debt service. China thus took a decisive step to begin the transition from onlending to SNG market access. The reform had two objectives: (a) ensuring fast access to market financing by SNGs when dealing with the global financial crisis, and (b) developing institutions for prudent management of subnational debt.

The State Council authorized the issuance of RMB 200 billion (US$30 billion) in provincial bonds in 2009.[5] However, policy makers recognized that important preconditions for the issuance of provincial bonds by provinces did not exist. It would take time to develop credit rating systems; SNGs would need to learn market access, including auctions; and the reform of the legal framework would need to carefully review the 1994 Budget Law, which restricts the access of subnationals to market borrowing. Thus, the issuance of provincial bonds needed to proceed in parallel with developing institutional, legal, and market infrastructure. The reform thus took a gradual, learn-by-doing approach, with the central government as the issuing agency and SNGs participating in the auctions to take advantage of the sovereign bond market experience and lower-cost financing. An additional RMB 200 billion (US$30 billion) of provincial bonds was authorized and issued in 2010 and again in 2011. In 2011, reform took a further step: the State Council approved piloting of direct bond issuance by four cities (RMB 23 billion of municipal bonds issued) without the central government acting as the issuing agency.[6]

The consequences of the reform are significant. The reform provided the instrument for the SNGs to finance capital investment and interact with market creditors; improved the intergovernmental fiscal relationship, particularly on capital expenditure; enabled the accumulation of lessons from experiments; and facilitated the process of establishing a regulatory framework for subnational debt management.

The transition from central government onlending to market access has been a challenge for many countries. Market development requires certain preconditions and coordinated reforms such as developing credit rating systems for subnational borrowers and establishing a regulatory framework for subnational debt management. Equally important, it takes time for SNGs to accumulate experience in, and develop capacity for, market access.

This chapter focuses on China's experience in developing market access through a series of coordinated reforms. The remainder of the chapter is organized as follows. Section two discusses the framework for subnational borrowing in China prior to 2009. Section three presents the transition from direct central government onlending to market access in China since 2009. Section four reviews the experiences and implications of the transition. Section five provides concluding remarks.

Frameworks for Subnational Borrowing in China Prior to 2009

Over the past two decades, China has been investing about 10 percent of GDP in infrastructure annually, a much higher rate than that of many developing economies. Large-scale investments in urban infrastructure—power, roads, railways, bridges and tunnels, water systems, and sanitation facilities—have facilitated rapid urbanization. The fiscal decentralization, started in the early 1980s and formalized in 1994 with the Tax Sharing System reform, granted major responsibility to SNGs in capital investments and operations of urban infrastructure.

Taxation and fiscal transfers were not sufficient to finance the large-scale urban infrastructure transformation required to accelerate economic growth in China. In addition to own revenues and fiscal transfers, debt financing has been important to SNGs. Prior to 2009, various financing channels were utilized, including central government onlending and off-budget vehicles.

Central Government Onlending

According to Article 28 of China's 1994 Budget Law, subnational budgets at various levels should be balanced; that is, expenditures shall not exceed revenues, and budget deficits shall be restricted. Consequently, SNGs should not finance expenditures through borrowing, such as from banks or by issuing bonds, except as otherwise prescribed by law or approved by the State Council.

Various formal financing channels had existed for SNGs. Since the early 1980s, the central government could borrow externally (for example, from international financial institutions and bilateral sources) and onlend to SNGs.[7] The Road Law of 1998 allows SNGs to raise funds for the construction of toll and nontoll roads and other transportation infrastructure.[8]

From 1998 to 2004, the Chinese Ministry of Finance (MOF) onlent funds to provincial governments by issuing treasury bonds as part of the countercyclical fiscal policy to mitigate the impact of the Asian financial crisis.[9] The fiscal policy was designed to expand domestic demand and stimulate economic growth. The onlent proceeds were required to be used mainly for investment in infrastructure such as large-scale construction projects as defined by the central government.[10] The MOF and the subnational financial departments were creditor and debtors, respectively. SNGs had no market interaction with creditors.

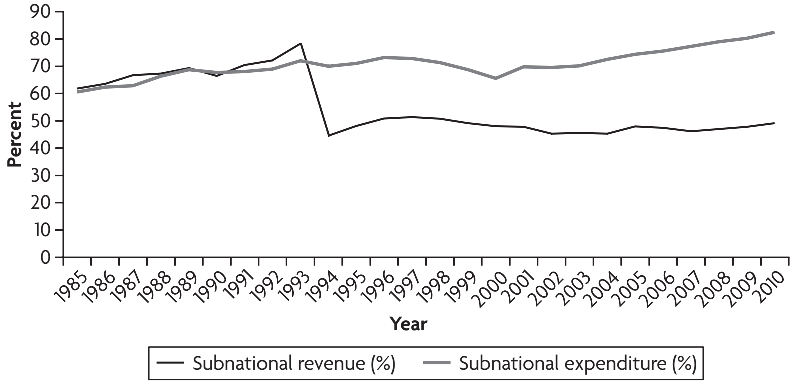
UDIC Borrowing

The demand for infrastructure due to rapid industrialization and urbanization increased an imbalance between subnational expenditure responsibilities and their revenue assignment, which motivated SNGs to seek different sources of financing. The UDICs—investment and financing platforms of SNGs—have since the mid-1990s become the main instrument for financing subnational infrastructure investments and construction.[11] Their rapid growth has helped close the widening financing gap between SNG expenditure responsibilities and revenue sources (figure 10.1).

In general, the UDICs have satisfied subnational financing demand without violating the Budget Law. The UDICs, controlled and financed by different levels of subnational government, are mainly responsible for capital investment and maintenance of infrastructure. Their financing sources come from land asset-based revenues, government equity, user charges, onlending from Treasury bonds, the central government subsidy, and government guarantees. The UDICs have borrowed from the financial markets (mainly the banking system) and issued bonds to raise funds. Bank loans have been the predominant debt instrument, but bond issuances have also grown, particularly since the late 2000s.

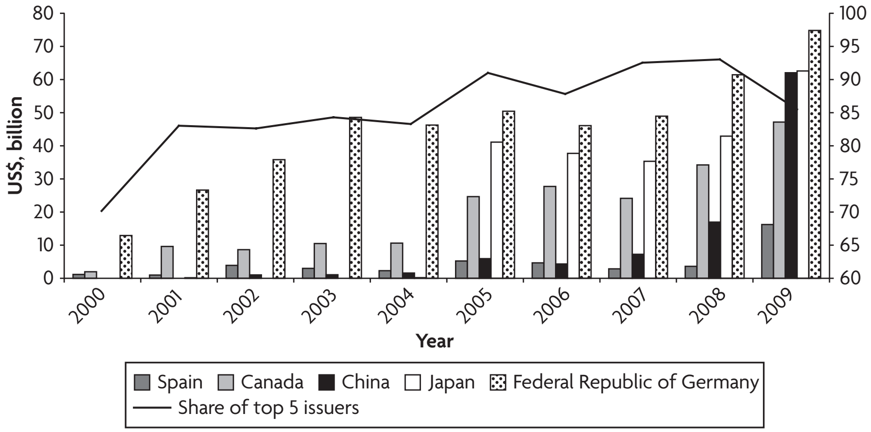
The State Council in 2004 granted the UDICs access to more financing channels and further encouraged expanding UDICs.[12] To put subnational bonds in China in international perspective, figure 10.2 represents subnational bond issuance from 2000 to 2009 by the top five countries outside the United States.[13] Subnational bond issuance by UDICs in China grew rapidly—from less than US$10 billion in 2002 to over US$60 billion in 2009. These bond issuances excluded the RMB 200 billion (US$30 billion) of provincial bonds issued by the central government on behalf of provinces in 2009.

Figure 10.1 Revenue and Expenditure of Subnational Governments in China, as Percentage of Total Government Revenue and Expenditure, 1985–2010



Source: National Bureau of Statistics 1993, 2011.

Figure 10.2 Top Five Countries Issuing Subnational Bonds, 2000–09 (Excluding the United States)



Source: Canuto and Liu 2010, with data source from DCM Analytics.
Note: In the United States, annual average issuance of subnational bonds from 2007 to 2011 was about US$450 billion (data source: Thomson Reuters).

To mitigate the impact of the 2008–09 global financial crisis, China launched an RMB 4 trillion fiscal stimulus package in late 2008. SNGs provided matching funds as part of the package, which spurred the rapid expansion of the UDICs. By 2010, total subnational debt (loans and bonds) outstanding in China amounted to RMB 10.7 trillion, about 27 percent of GDP.[14]

Although UDICs significantly improved the urban infrastructure, their rapid growth caused both a significant increase in local debt and new challenges, such as discretionary operations and risky guarantees from the SNGs. To control the increasing debt risk, the central government required stricter regulation of SNG liabilities.[15] It required that different levels of governments clean up UDIC liabilities and apply different treatment strategies to different types of debt to ensure credit safety.

Land Asset-Based Financing

SNGs have also utilized land assets as an important source of financing infrastructure. Land asset-based financing is an important ingredient of

SNG finance in many countries. Land frequently is the most valuable asset on the asset side of subnational balance sheets. There are various instruments for converting public land rights to cash or infrastructure, including "capital" land financing via direct sales of land and using land as collateral for borrowing (a practice that has a long history of financing urban investment). Land is often the most important public contribution to public-private partnerships that build transit lines, airports, or other large infrastructure projects. Beyond physical land, rights to more intensive land development—a higher Floor Space Index or higher Floor Area Ratio—may also be sold by public development agencies. These "excess density rights" in effect represent the publicly controlled share of privately owned land. The development rights have economic value that can be sold by public authorities.[16]

SNGs in China have actively used land asset-based financing since the mid-1990s.[17] There are two important aspects to such financing: (a) land asset-based financing and UDICs are linked—the UDICs use various instruments of land asset-based financing to convert land value into infrastructure assets;[18] and (b) UDICs have used publicly owned land as collateral for borrowing to finance investment.[19] (See section four for a discussion on land financing.)

Informal Practices of Subnational Borrowing

Given the constraints placed on SNG formal borrowing, SNG informal borrowing has grown, and it can take the form of arrears on wages and on what is owed to suppliers. A uniform statistical framework for subnational debt is lacking. Apart from the technical issues, the inaccuracy of statistical data may also be attributed to different motivations on the part of local governments, such as overstating the size of liabilities to win potential assistance from the higher-level government, or understating it to demonstrate governing performance. And the measurement becomes more problematic when taking into account implicit and contingent liabilities.

One example of such informal borrowing is the accumulation of rural education debt. China started promoting nine-year compulsory education in rural areas throughout the country in the mid-1980s. For the next 10 years, local governments (towns and villages), with limited fiscal resources, resorted to borrowing to build or improve school facilitates to help meet the minimum facility standards for all schools. In 2000, nine-year compulsory education became universal and China achieved a historic improvement in education. Meanwhile, the accumulation of rural compulsory education debt had become a significant fiscal burden on local governments. The aggregate rural education debt was about RMB 110 billion[20] at the end of 2007 (3.9 percent of aggregate subnational own fiscal revenue, excluding transfers), of which about RMB 80 billion was used to finance capital expenditure, and about RMB 30 billion was used to finance operational expenditures. The central government later restructured the rural education debt with innovative reforms (see chapter 2 by Liu and Qiao in this volume).[21]

Toward a New System of Financing

The financing channels prior to 2009 contributed to the rapid urbanization and transformation of the urban infrastructure landscape in China. Table 10.1 shows the rapid growth of urban infrastructure in China. China also has the world's second-largest highway network, the world's most densely trafficked railway network, the largest high-speed rail network, the world's three longest sea bridges, and three of the world's four-largest container ports.[22]

Table 10.1 Urban Infrastructure Development in China: Selected Indicators, 1990–2009

Indicators	1990	1995	2000	2009
Population density of city districts (persons/square kilometer)	279.0	322.0	442.0	2147.0
Water consumption for residential use (100 million cubic meters)	100.1	158.1	200.0	233.4
Consumption of natural gas for residential use (100 million cubic meters)	11.6	16.4	24.8	91.3
Coverage rate of urban population with access to gas (%)	19.1	34.3	45.4	91.4
Area of centralized heating (100 million square meters)	2.1	6.5	11.1	38.0
Length of city sewage pipes (10,000 kilometers)	5.8	11.0	14.2	34.4
Number of public vehicles under operation at year end (buses and trolley buses, etc.) (10,000 units)	6.2	13.7	22.6	37.1
Per capita area of parks and green land (square meters)	1.8	2.5	3.7	10.7
Volume of garbage disposal (10,000 tons)	6,767.0	10,671.0	11,818.9	15,733.7

Source: National Bureau of Statistics 2010.

The limitations of the financing models prior to 2009 became evident in the mid-2000s, as did the conditions facilitating market access.

First, it was recognized that the direct central government onlending to SNGs separates the borrowing power (the central government) and the payment obligations (SNGs). Basically, debt issued by the central government and onlent to SNGs is difficult to classify as either central or subnational debt. In practice, the onlending funds were included in neither the central nor the subnational budget. SNGs have no market interaction with creditors.

When the security markets, particularly the sovereign debt market, were in their nascent stage of development, the central government's targeted onlending instruments would help meet the urgent funding needs without waiting for the eventual development of capital markets. As the sovereign debt market was developing and maturing, it helped lay a solid foundation for the development of the subsovereign debt market. In the 2000s, China's sovereign debt market was developing fast.

Second, UDICs' off-budget debt and liabilities are nontransparent and difficult to monitor. This type of debt not only creates contingent liabilities for SNGs, but it may also implicate the central budget. More important, the information on subnational debt was asymmetric between the central government and the SNGs due to SNG off-budget borrowing.

By 2009, the Chinese government was ready to address the contingent liability issue. The fiscal system after the tax-sharing reform in 1994 delineates the intergovernmental fiscal relation between the central government and SNGs. During the 15 years of development since 1994, the division of fiscal revenue and responsibility between the central government and SNGs had become clearer. In particular, SNGs take the responsibility for local economic development, which makes it possible for the hard budget constraint between the central government and SNGs. This implies that SNGs have become more independent in dealing with risks.

At the same time, a series of reforms in fiscal budget management (for example, department budget reform and the national treasury single account system reform launched in 2001;[23] and budget expenditure, particularly project expenditure reforms in 2005) improved the transparency of budget management and facilitated subnational bond financing in the capital markets. Moreover, reforms in 2003 related to the state-owned asset management system affirm governments' property rights on state-owned enterprises. Meanwhile, the reforms also affirm that the ownership of a public enterprise would be separated from the management of the public enterprise, so that the management can follow commercial and market principles.[24] The regulations on state-owned property further clarify the rights and obligations of state-owned assets. And these policies could help prevent public institutions from transferring debt risks to government agencies.[25]

Third, financing infrastructure through land lease is not sustainable in the long run, because of its one-time nature.[26] The practice of UDIC borrowing through securitization of land values magnifies the borrowing risks, because land values decline during periods of economic stress, when it is more difficult to finance loan repayments. There is potential for heightened systemic risk when the entire subnational sector relies heavily on land and land values to provide security for subnational borrowing.[27]

There are tremendous benefits from granting SNGs access to financial markets, and debt financing would be a more efficient and equitable approach to finance infrastructure (Liu 2008). For the central government, the benefits include (a) strengthening fiscal transparency of SNGs, (b) helping the central government assess the fiscal capacity of SNGs and supervise subnational budgets, (c) providing information for the determination of intergovernmental transfers, and (d) providing a self-sustaining mechanism that clearly delineates the rights and obligations of borrowed funds and decreases the soft budget constraint.

For the SNGs, the benefits of accessing capital markets would include (a) providing SNGs with more financing sources for infrastructure investments, (b) creating profit- and risk-sharing mechanisms between creditors and debtors, and (c) exposing SNGs to market discipline and reporting requirements, which helps improve government accountability.[28]

The capital market might also benefit from subnational bond financing. Compared to corporate bonds or stocks, investments in subnational bonds can be relatively less risky, rewarding investors with stable and attractive returns. Subnational bond financing provides additional financial products in the securities market, diversifying the securities structure. Subnational bonds can better fit the asset and liability structure of such investors as life insurance companies, mutual funds, and pension funds. In addition, issuing subnational bonds might not only increase securities volume, but also add new elements to diversify the securities markets.[29]

Expanding Market Access since 2009

Since 2009, China has moved forward with developing subnational capital markets in three significant ways: (a) allowing the issuance of provincial bonds in 2009, 2010, and 2011 totaling RMB 600 billion (approximately US$90 billion), (b) piloting the direct issuance of municipal bonds by four cities in 2011, and (c) developing an institutional framework for managing subnational debt.

Issuance of Provincial Bonds

The 2008–09 global financial crisis provided a broad context, and an opportunity, for the transition toward market access. The State Council authorized the issuance of provincial bonds in 2009[30] as part of the large-scale stimulus package. SNGs were to provide RMB 2.82 trillion in investments, accounting for 71 percent of the RMB 4 trillion fiscal package, to match the RMB 1.18 trillion in central government investments.[31]

The issuance of provincial bonds in 2009 differs from the period 1998–2004, when the MOF issued treasury bonds and onlent the proceeds to SNGs for financing infrastructure, as part of the countercyclical fiscal policy to mitigate the impact of the Asian financial crisis. In 2009, provincial bonds would become a direct source of financing for SNGs.

The Chinese government began to prepare for expanding subnational market access well before the 2008–09 global financial crisis. As noted, a series of reforms in budget management and in the state-owned asset management system had laid the groundwork. The government also conducted research on international experience in subnational debt management[32] and an audit of UDIC debt. However, allowing provinces to directly issue bonds would require preconditions, many of which, such as subnational credit ratings, were absent and would take time to complete. Provinces had no experience with the securities markets, such as dealing with underwriters, dealers, and auctions. It also takes time to build a unified management system of subnational bonds.

The issuance of provincial bonds thus took a gradual approach. Instead of letting provinces directly issue bonds, the central government issued RMB 200 billion (US$30 billion) in bonds in 2009 on behalf of the provincial governments. These bonds were booked directly as provincials' own debt. Essentially, subnational bonds in 2009 were issued by the MOF acting as the issuing agent through the existing channels of treasury bonds, with the participation of SNGs in market activities such as auctions.

On the one hand, the reform could build a close link between debt issuance and payment responsibility and allow SNGs to acquire experience in market access. On the other hand, the process of issuance made full use of the rich experience of the MOF in the Treasury bond market, including the ministry's matured techniques and its established relationships with investors. The national Treasury market has developed rapidly. As of 2011, the outstanding balance of T-bonds reached RMB 6.8 trillion, ranking second in Asia and sixth globally.[33] The process also lowered the financing cost for SNGs and improved issuance efficiency. In addition, investors received a guarantee that they would receive principal and interest on time.

In general, the 2009 SNG bond is a tradable book-entry bond. The provincial governments[34] were the issuers and debtors. On behalf of provinces, the MOF acted as the issuing agency and pays the debt service and the issuance fee from the respective provincial escrow account within the MOF.[35] The term of all bonds was three years, and the annual payments and the interest rate were priced through public bidding. The funds financed by subnational bonds cannot be used to finance current expenditure,[36] and should mainly invest in the areas that match central government investment on public projects that had difficulty attracting private investments.[37] The bond proceeds cannot finance commercial projects that can obtain private financing.[38]

Among the different models of subnational debt management (Ter-Minassian and Craig 1997), China followed the model of Direct Administrative Controls for the subnational bonds. The central government allocated the RMB 200 billion quota of bond issuance among the SNGs. The allocation of the quota followed a designated formula, including the required subnational matching funds for projects in which the central government invested, funds required for subnational infrastructure projects, and the fiscal capacity of repayment. The required subnationals' matching funds represented the most important factor in the formula. To calculate the fiscal capacity of repayment in the formula, considerations included the debt ratio, the estimated growth rate of subnational revenue, and the fiscal capacity of each jurisdiction.

The middle and western regions had larger infrastructure demands than those of the coastal regions. Consequently, the 2009 central government stimulus package gave more weight to projects in the middle and western regions. The SNGs in these regions had fewer fiscal resources to provide the matching funds. To achieve a better performance of the stimulus package, it was necessary to provide more quotas to the middle and western regions. The amount of issued bonds for the eastern, middle, and western regions was RMB 60.3 billion, RMB 64.7 billion, and RMB 75 billion, respectively, accounting for 30, 32, and 38 percent of the total bonds issued.

Within the approved quotas and the framework set by the central government, SNGs are responsible for choosing and appraising projects, formulating their budgets, and obtaining approval from their respective People's Congress. The MOF then issues SNG bonds, following the issuance plan agreed with the SNG, on the basis of "the ready one will be issued" principle to raise funds for the SNG quickly, and promote the effective implementation of the fiscal policy.

The MOF formulated a series of regulatory rules with respect to the inclusion of debt service as part of subnational budget management.[39] In particular, to strengthen budget administration, the MOF enacted the "Regulation of the Budget Administration of the 2009 Subnational Government Bond Funds," which requires that the proceeds from the issuance of the SNG bonds and the debt service be incorporated into subnational budget management. The adjusted budget proposal should be submitted for approval of the People's Congress Standing Committee at the same subnational level. In addition, the departments or units as the users of bond funds should incorporate the expenditure into the department's or unit's budget.

The MOF also established an improved system for project application, approval, performance assessment, and supervision to enhance the efficiency of fund administration. Under the system, the SNGs must accept inspection of how the supervision department and audit department use the funds. Those violating the relevant regulations, such as by intercepting and misappropriating the bond funds from the designated use, will be penalized in accordance with the Fiscal Offense Punishment Act (State Council, No. 427 in 2004).

To ensure that the SNGs actually fulfill their repayment responsibility, the solvency of a city, county, department, and unit as the user of the bonds was taken into account to assess the default risk. The repayment schedules were projected to ensure the availability of sources for timely payment of principal, interest, and issuance cost to the MOF. In addition, penalty rules were implemented. Each SNG, as a debtor, should comprehensively arrange its integrated financial resources and carry the debt responsibilities. In particular, it should pay the bond principal and interest and issuance fees to the MOF on time. Those that failed to pay on time must pay penalty interest to the MOF,[40] and, if the principal, interest, issuance cost, and penalty interest are overdue, the MOF could withhold the amount during the annual settlement between the MOF and the SNG.

Developments since 2010

The subnational bonds issued in 2009 greatly strengthened the fiscal capacity of local governments to provide matching funds and expand infrastructure investment. However, challenges emerged with respect to subnational autonomy in spending the bond proceeds and the maturity of the bonds. Although the regulations clearly required SNGs to allocate bond funds to finance those projects also invested in by the central government, some SNGs allocated the bonds funds to local projects. Meanwhile, the bond maturity term of three years was less attractive to the underwriters and put repayment pressures on some SNGs.

To address these issues, the MOF took the following additional steps in 2010:

- Bonds with a five-year maturity were issued to meet the market demand and the fiscal capacity of SNGs in the medium term. The five-year maturity bonds totaled RMB 61.6 billion of RMB 200 billion of bonds in 2010.

- The MOF granted SNGs more fiscal autonomy in using the bond funds, not only for the matching part of the projects the central government invested in, but also for the projects invested by the SNGs, as long as these local projects followed the investment priorities specified by the central government.
- The quota for allocating the bonds was adjusted, while keeping the total issuance of subnational bonds at RMB 200 billion in 2010 (the same as in 2009).[41]
- Efforts were made to reduce the issuance cost by joint issuances of the subnational bonds for different jurisdictions and to improve the liquidity by increasing the volume of each issuance. The investor base of the subnational bonds has been expanded to all book-entry underwriters of the treasury bonds, and the coordination between underwriters and SNG finance departments has been strengthened. In 2011, the same amount of subnational bonds was issued. Table 10.2 summarizes the subnational bonds issued during 2009–11 (for 2011, table 10.2 includes the municipal bonds directly issued by four cities as part of RMB 200 billion, as explained next).

In 2011, the State Council authorized four cities (Beijing, Shanghai, Shenzhen, and Zhejiang) to pilot municipal bond issuance.[42] These municipal bonds differ from UDIC bonds; the former are secured by the full faith and credit of the municipal government issuer, and the latter are secured by the proceeds from the project and from specific land assets.[43] These municipal bonds also differ from the 2009–11 provincial bonds. The municipal bonds were issued in 2011 directly by four cities without the central government acting as the issuing agency. It is one step further toward SNGs being fully responsible for their debt payments.

The municipal bonds directly issued by the four cities were included in the quota set by the central government. In fact, the maturity, bidding methods, and investor base of the municipal bonds were not different from those of the provincial bonds. The yield of these municipal bonds was 5–10 basis points lower than the Treasury bonds (see table 10.3); this reflects inefficient price formation in debt markets, which are still at the development stage.

Table 10.2 Subnational Bonds Issued in China, 2009–11
RMB billions

	2009		2010		2011	
Region	**Amount**	**% of total**	**Amount**	**% of total**	**Amount**	**% of total**
Sichuan	18.0	9.0	18	9.0	13.5	6.75
Guangdong	10.9	5.45	9.1	4.55	9.1	4.55
Henan	8.8	4.4	9.3	4.65	9.3	4.65
Jiangsu	8.4	4.2	8.9	4.45	8.9	4.45
Yunnan	8.4	4.2	7.5	3.75	7.9	3.95
Zhejiang	8.2	4.1	8.0	4.0	8.0	4.0
Hunan	8.2	4.1	8.9	4.45	8.9	4.45
Hubei	8.1	4.05	8.6	4.3	8.6	4.3
Anhui	7.7	3.85	8.9	4.45	9.0	4.5
Shanghai	7.6	3.8	7.1	3.55	7.1	3.55
Shandong	7.0	3.5	6.9	3.45	7.3	3.65
Liaoning	6.6	3.3	6.0	3.0	6.0	3.0
Ganshu	6.5	3.25	5.5	2.75	5.9	2.95
Guangxi	6.5	3.25	5.5	2.75	6.0	3.0
Guizhou	6.4	3.2	5.4	2.7	5.4	2.7
Shan'xi	6.3	3.15	6.3	3.15	6.8	3.4
Jiangxi	6.2	3.1	6.5	3.25	7.0	3.5
Hebei	6.0	3.0	6.9	3.45	7.3	3.65
Helongjiang	6.0	3.0	6.9	3.45	6.9	3.45
Chongqing	5.8	2.9	4.9	2.45	5	2.5
Inner Mongolia	5.7	2.85	5.9	2.95	5.9	2.95
Beijing	5.6	2.8	5.4	2.7	5.4	2.7
Jilin	5.5	2.75	6.3	3.15	6.3	3.15
Xingjiang	5.5	2.75	6.0	3.0	6.0	3.0
Shanxi	5.3	2.65	5.1	2.55	5.1	2.55
Fujian	3.4	1.7	6.1	3.05	5.5	2.75
Ningxia	3.0	1.5	1.8	0.9	2.6	1.3
Hainan	2.9	1.45	2.5	1.25	2.9	1.45
Qinghai	2.9	1.45	3.3	1.65	3.9	1.95
Tianjing	2.6	1.3	2.5	1.25	2.5	1.25
Total	200	100	200	100	200	100

Source: MOF.

Note: Within the RMB 200 billion of bonds in 2011, Shanghai, Guangdong, Zhejiang, and Shenzhen directly issued RMB 7.1 billion, RMB 6.9 billion, RMB 6.7 billion, and RMB 2.2 billion, respectively.

Table 10.3 Municipal Bonds Directly Issued by Four Cities in 2011

		3-year maturity		5-year maturity	
City	Date of issuance	Volume	Yield (%)	Volume	Yield (%)
Shanghai	November 15, 2011	3.6	3.10	3.5	3.30
Guangdong	November 18, 2011	3.45	3.08	3.45	3.29
Zhejiang	November 21, 2011	3.3	3.01	3.4	3.24
Shenzhen	November 28, 2011	1.1	3.03	1.1	3.25

Sources: Data compiled based on DF Daily 2011 and Shanghai Security 2011.

Institutional Reforms

Institutional reforms started even before the 2009 decision to issue provincial bonds, including fiscal budget management and transparency, and separating management from ownership in government-owned enterprises (section two). The new bond instrument has aimed at creating a framework for medium-term capital budgeting for infrastructure investments. Past budgeting practice did not separate financing of capital budgeting from that of current expenditure. Long-term capital investments will need to be financed through debt for intergenerational equity. With the new instrument, SNGs can use the debt to finance capital outlays under newly developed budgeting procedures. Other institutional reforms since 2009 have covered, among other things, UDICs and developing a monitoring system for fiscal risks stemming from subnational debt. Provinces and cities have also launched reform experiments.

A major reform was put forward by the State Council in 2010 on the regulation of UDICs.[44] The directive authorized the audit of UDIC debt and classified the UDIC debt into three categories: (a) debt issued for public purposes and implicitly securitized by budget revenues, (b) debt issued for public purposes but securitized by the revenues generated by the project being financed by debt, and (c) debt issued for commercial purposes.

The classification of the debt is significant in laying the groundwork for the future development of different debt instruments, such as general obligation bonds and revenue bonds, and would limit the debt financing to public investments, which has become a general principle in the subnational debt regulatory framework in many countries (Liu and Waibel 2008). The directive also specified the management of the UDIC, differentiating UDICs that are financially self-sustainable from those that rely on budget support. Furthermore, bank loans to UDICs will need to follow credit risk analysis, and guarantees provided to UDICs would be regulated.

The government is also studying international experience in developing indictors to monitor risks from subnational debt and establishing debt limits to guide subnational entities' investment and borrowing plans. International experience shows that there is a trade-off in establishing debt limits; setting the thresholds too tight can hamper growth by severely restricting subnational infrastructure investment, while loosening thresholds can endanger macroeconomic and financial stability by encouraging excessive subnational borrowing (Liu and Pradelli 2012).

Provinces and cities have also piloted reforms. Many city governments, including Guiyang, Kunming, Shanghai, and Xian, have audited their own UDIC debt and are developing institutional frameworks to better link debt financing with capital investment plans and the master plan of the city and the medium-term fiscal framework.

Experience and Implications of Expanding Market Access

The immediate objective of the transition to market access was to establish a formal financing channel through which debt instruments could be used quickly to finance subnational capital expenditure, particularly to finance SNG matching funds for the large-scale projects identified by the central government as key to domestic integration and for which the central government also invested its own funds. The long-term objective is to develop transparent and sustainable channels of financing for SNG capital investments and to support economic growth.

Transitional Instrument of Subnational Bonds

The issuance of provincial bonds was successful in establishing a new instrument to finance subnational capital expenditure. It helped smooth the economic cyclicality through the central stimulus package by providing SNGs with matching funds for the projects in which the central government co-invested. Meanwhile, it promoted regional development, especially in the less developed regions. For example, Xinjiang allocated the bond proceeds mainly for building hospitals and schools in seismic areas, and Sichuan ensured smooth reconstruction after the Wenchuan earthquake in May 2008. More important, China took the first step in establishing a budget framework to guide capital budgeting management, because the subnational bonds are incorporated into the budget management, in particular the financing of the capital budget. The SNGs for the first time have direct market interaction with creditors and are responsible for the debt repayments.

Notwithstanding the achievements, the issuance of provincial bonds in 2009–11 was transitional in nature. The subnational bonds took advantage of the central government's strong credit, since the MOF was the issuer on behalf of SNGs. This essentially lowered the cost of borrowing, which was important when implementing a large-scale fiscal stimulus package. The average interest of the three-year bonds issued in 2009 was only 1.91 percent and that of five-year bonds was only 2.96 percent,[45] which was significantly lower than that of commercial banks. Meanwhile, there was no significant difference in the interest rates across jurisdictions. Subnational bond interest rates did not reflect the diverse levels of economic development of different jurisdictions and the underlying credit conditions of subnational debtors.

The instrument was only the first step in clarifying the relationship between debt issuance and debt service obligations, in that the debtors of subnational bonds are the provincial governments, and the central government remains the issuer. Thus, the central government has to assume responsibility for the debt in case of default,[46] although the SNG escrow accounts with the MOF and the annual transaction settlement would greatly reduce the risks to the central government. The pilot in municipal bond issuance directly by four cities without sovereign guarantee represents a further step in linking debt issuer and debt service obligation.

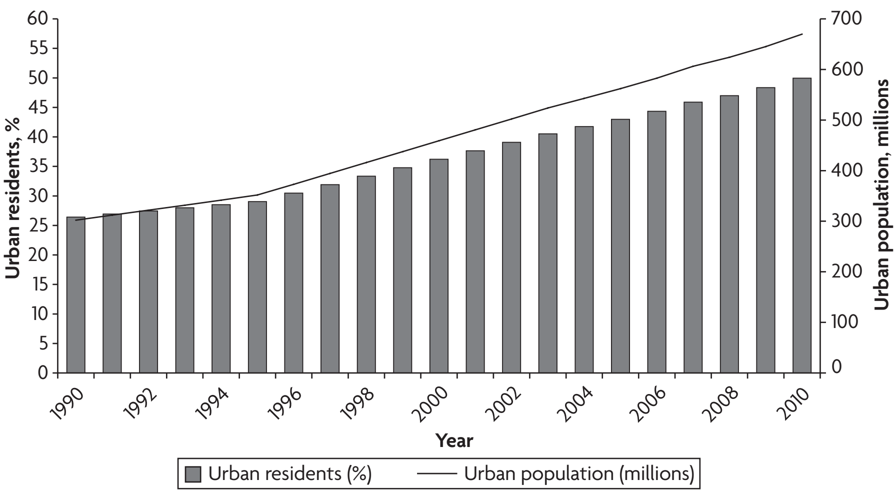
The 2009–11 reform could be regarded as the beginning steps toward achieving the implicit objective of developing formal financing channels of subnational capital investments. Fundamentally, the factors contributing to the fast growth of subnational debt in China can be classified into the demand side and the supply side.

Strong Demand for Subnational Debt in China

A number of factors have contributed to the strong demand for subnational debt instruments since the 1990s. These factors include rapid urbanization, rapid growth in urban land value, rapid economic growth, and the large financing gap of subnational government fiscal accounts. Most of these factors are expected to continue, underlining the significance of reform undertaken by the Chinese government in reforming the management of subnational debt financing.

Urbanization. China has been undergoing rapid urbanization and industrialization since the 1990s. The percentage of urban residents in the total population increased from 26 percent in 1990 to 48.3 percent in 2009; urban residents more than doubled, from 302 million to about 645 million during the same period (figure 10.3). This has significantly challenged the ability of SNGs to provide public services, such as power, water and sanitation facilities, parks, bridges and roads, subways, and telecommunication networks. Fiscal transfers and taxation alone cannot adequately finance the scale of infrastructure investments required to accommodate the pace of urbanization. In a supply-demand analytic framework, urbanization shifts the demand curve of subnational

Figure 10.3 Rapid Urbanization in China, 1990–2010



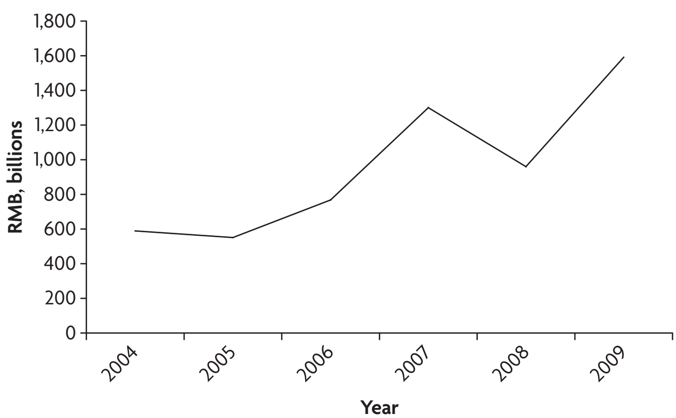
Source: National Bureau of Statistics 2010.

borrowing to the right, resulting in the large-scale demand for subnational debt.

The land-asset effects. The use of land assets to secure financing is prevalent in China. In fact, land-asset revenues have been one of the most important extrabudgetary financing sources for SNGs in China. Under Chinese law, governments hold exclusive ownership of land and are able to exercise power over land asset-based financing. As shown in figure 10.4, the annual amount of land-transfer fees collected in China has grown rapidly,[47] especially in 2007 and 2009. SNGs in China have successfully financed infrastructure through land asset instruments. As noted, land asset-based financing is an important ingredient of SNG finance in many countries (Petersen and Kaganova 2010). In China, investment financing from proceeds from land leasing and public bank lending securitized by land and property valuation accounts for 80–90 percent of SNG infrastructure financing (Liu 2008).

However, the land financing policy created a huge increase in the perceived wealth of SNGs. Since all lands are publicly owned, SNGs perceive appreciation of the value of their assets due to the rising real estate prices in recent years.[48] The perception of the growth in wealth is further augmented by the one-time nature of land transactions in China that allows SNGs to collect 50- or 70-year leasing fees up front.[49] International

Figure 10.4 Annual Land Transfer Fee in China, 2004–09

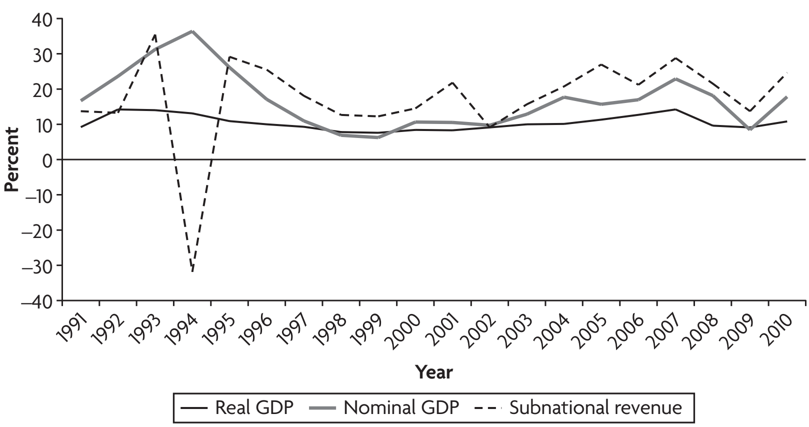


Source: Ministry of Land and Resources, China.

experience shows that during the high-growth period of urban development, publicly owned land often has been used as collateral for borrowing to finance subnational public investment. The expectation that land values will increase with urban growth has made land an attractive asset for loan collateral, for both public borrowers and private lenders. However, this practice magnifies the risks, because land values decline in periods of economic stress, when it is most difficult to finance loan repayments. There is a potential for heightened systemic risk when the entire subnational sector relies heavily on land and land values to provide security for subnational borrowing (Peterson and Kaganova 2010).

Growth expectations. Growth expectations come from the optimistic view of local officials about the prospect of development of the local economy and fiscal revenue. As shown in figure 10.5, China has experienced decades of rapid economic growth. Consequently, subnational government revenues in China show a strong growth trend. Subnational officials might perceive that this growth would continue for a relatively long period and that more revenues will be generated in the future. Thus, subnational officials tend to overborrow, because they believe that the resulting deficit will be temporary and will be covered in the foreseeable future (see, for example, Wang, Xu, and Li 2009).

Figure 10.5 GDP Growth Rates and Subnational Revenue, 1991–2010



Source: National Bureau of Statistics 2011.
Note: GDP = gross domestic product.

Subnational financing gap. One of the major fiscal issues in China is the increasing disparity between subnational government expenditure responsibilities and revenues[50] (as manifested in figure 10.1), which has contributed to the use of debt instruments to close the financing gap. Several factors with respect to intergovernmental fiscal relations have contributed to the imbalance of expenditure and revenue (Martinez-Vazquez and Qiao 2010).

First, SNGs bear a heavy expenditure burden (table 10.4), especially county-level governments taking the main responsibility of basic service provision such as basic education, health care, and social welfare. Notably, the assignment of social security services to subprovincial governments helped generate operational deficits and implicit liabilities. In addition, with the extensive cosharing or concurrent responsibilities, the upper-level governments have assigned unfunded or insufficiently funded mandates to the lower levels.

Table 10.4 Relative Shares of Expenditure at Different Government Levels in China, 2003
percent

Expenditure	Central	Provincial	Prefecture	County and under
Total	30	18	22	30
Capital investment	44	23	22	11
Agriculture expenditure	12	46	11	30
Education	8	15	18	60
Scientific research	63	23	9	5
Health care	3	22	32	43
Social security	11	39	32	18
Government administration	19	11	22	48
Public security and procuratorial agencies, court of justice	5	25	34	35
National defense	99	1	0	0
Foreign affairs	87	13	0	0
Foreign aid	100	0	0	0
Other	29	16	25	31

Source: Martinez-Vazquez and Qiao 2010.

Second, while decentralizing public service provision responsibilities, the tax-sharing reform in 1994 allowed SNGs to share major taxes, such as the value-added tax and the personal and corporate income tax.[51] Although they have some taxation powers, such as a business tax, in general, SNG taxation power is limited. Moreover, the property tax system, which generally serves as an important revenue source for SNGs in international practice, is still in its embryonic form. Table 10.4 shows that SNGs bore the increasing burden of decentralized expenditure responsibilities (over 90 percent in education and health), but the share of their revenues from various sources has never exceeded 50 percent of total government revenue for the past decade.

Third, although the intergovernmental transfer system mitigates the fiscal imbalance to some extent, there are still significant fiscal gaps for some SNGs, particularly those in less developed jurisdictions. As one of the most important components in the transfer system, the tax rebate depends heavily on historical record instead of on the true fiscal gap between responsibilities and revenues.

In addition, the lack of accountability, imperfect budgetary management, and feeding finance[52] in some jurisdictions also contributed to the increasing fiscal gaps (Qiao and Shah 2006; Zhu 1999). The current criteria for performance evaluation put a relatively high weight on GDP growth, so subnational officials are motivated to expand public investment and attract private investment. Cai and Treisman (2004) give specific examples of this competition for investments, which may compromise subnational tax collection and lead to more subnational debt financing. The central government has taken steps to improve the effectiveness and transparency of the budget.

The Supply Side of Debt Instruments

The structure of the financial market has an important bearing on the growth and risk control of subnational debt in China. With rapid economic growth, China has made significant strides in the development of financial markets. There are remaining challenges, two of which—the governance structure and the excessive liquidity in the financial market—are particularly relevant for the further development and reform of the subnational credit market.

On the issue of governance structure in the financial sector, market discipline will need to play an important role in regulating the debt financing of SNGs. Market discipline will require fiscal transparency from debtors, a risk control system for creditors, and the expectation of no bailout in the event of default. The institutional capacity to manage fiscal transparency is gradually developing in China, and the independent credit rating system is in the early stages of development. The MOF is developing an in-house credit-rating system to audit and monitor the size of the subnational debt liabilities. The National Development and Reform Commission has worked with Standard and Poor's to undertake the credit ratings of select UDICs.

On the risk control of creditors, many loan decisions in the past have been made without proper risk assessment, due to a lack of sufficient risk regulations in the banking system. The lack of comprehensive data for subnational fiscal accounts has contributed to weak risk control in assessing the quality of lending to the subnational sector. Moreover, facing competition, banks may ignore signals of possible insolvency and tolerate the financial risk of subnational insolvency since the soft budget constraint problem strengthens their expectation of a bailout (Wu, Wu, and Liu 2008). The State Council Directive of June 10, 2010, aims at strengthening credit risk analysis. The Development Bank of China, a major subnational lender, has increased emphasis on risk control.[53]

The interventions of some local officials in the loan decisions have also encouraged the growth of subnational debt. Local officials in China still have various channels through which to influence bank lending decisions. Most financial institutions in China are government owned and need the support of SNGs for their local operations (Qiao 2012). In particular, subnational government officials may play a role in promoting executives of local branches of some state-owned financial institutions (Wang, Xu, and Li 2009).

China has made significant progress in reforming its financial markets, which has resulted in increased competition among government-owned banks, development of a sovereign debt market, development of an interbanking system, and development of nonbanking financial institutions. Nonetheless, interest rates remain controlled, making it difficult to properly price risks and returns. Consequently, the true costs of capital are not reflected and the supply curve of debt services has become relatively flat.

International experience shows that an efficient central government bond market is important for an SNG bond market to function efficiently. China has the potential to improve the efficiency of the government bond market, which underpins the growth of diversified and sophisticated fixed-income markets. Future reform areas include strengthening coordination among government entities in developing and implementing regulations, improving the Inter-Bank Bond Market and the repo market, and developing a diverse investor base.[54]

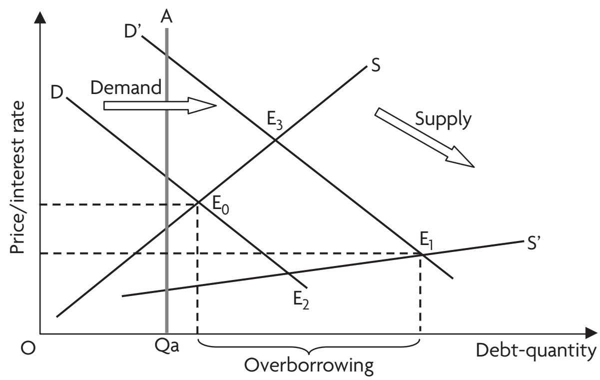
Demand for investment opportunities by individual and institutional investors appears to be increasing due to high savings rates and excessive market liquidity. It is well known that one of the driving forces of the Chinese economy is its high household savings rate (Xie 2011). Increasing personal income and the high savings rate have led to an increasing trend of household deposits (Yu 2006). Thus, strong demand for investment instruments exists among individual and institutional investors. The increasing savings deposits accumulated in financial institutions induces their strong investment demand.

The Budget Law restricts SNGs from running deficits without approval of the State Council, so SNGs set up UDICs that borrow mainly from state-owned banks. Since there were no clear regulatory and operational rules concerning UDIC borrowing, both SNGs and banks could be influenced by the perception of the potential for bailouts (Jia 2012).

The effects of all these factors can be viewed more clearly in the demand-supply graph of debt services, as illustrated in figure 10.6. In the figure, lines D and S represent the initial debt demand and supply curves, respectively. Line D shows the SNG demand for debt to finance capital expenditure driven by the growing urbanization process. Efficient capital markets supply funds according to correctly priced risks and returns, represented in the supply curve S. Lines S and D jointly form the desirable equilibrium E_0. Other demand-side factors distort E_0 by shifting the demand curve to the right, indicated by the new demand curve D'.

The supply-side factors have two impacts on the original supply curve S. These factors first move the supply curve to the right, since they increase the debt quantity for any given capital costs. Moreover, the factors have an extra impact on preventing the markets from pricing risks

Figure 10.6 Formation of Debt Equilibrium, China



Source: Qiao 2012.

and returns correctly, consequently shifting the supply curve flatter. The two effects form the new supply curve S'. The new demand curve and supply curve determine the new equilibrium E_1. The new equilibrium lies to the far right of the desirable equilibrium, indicating a large increase in the debt service costs. Overborrowing by SNGs is the difference between quantities of the equilibrium E_1 and E_0.

The Budget Law establishes a binding ceiling of debt quantity that is 0 or close to 0 over the market, forcing the entire market to be hidden. In figure 10.6, the ceiling policy is indicated by line A, which sets a binding quantity of Q_a, and all quantities above Q_a are hidden.

Summary

Subnational debt in China is unlikely to pose systematic macroeconomic risks. The subnational debt outstanding in China was estimated at RMB 10.7 trillion at end-2010, about 27 percent of GDP. China's sovereign debt accounted for 17 percent of GDP at end-2010.[55] The combined public (sovereign and subsovereign) debt was below 50 percent of GDP, lower than in many other countries. China's central government has been running low fiscal deficits in the past 10 years, and 2.5 and 2 percent of GDP in 2010 and 2011, respectively.[56] Furthermore, the institutional reforms (see section three) aim at developing a comprehensive regulatory framework to strengthen the management of subnational debt.

The rapid urbanization and industrialization and the large subnational fiscal gap demanded subnational borrowing, and the subnational borrowing significantly improved infrastructure and accelerated economic growth. A more efficient market of subnational government debt will facilitate the sustainable financing of infrastructure.

On the demand side, the SNGs have shown a relatively high degree of administrative discretion in expenditure and are capable of influencing decisions of financial institutions. On the supply side, the banking system operates in an environment of excessive liquidity and tends to yield to pressures from the demand side. These have encouraged the overspending and overborrowing behavior of SNGs in China, bringing unregulated risks. Consequently, it is necessary to improve both the overall fiscal system and the local incentive system to effectively block the informal borrowing.

The market of subnational government debt also needs more transparency. Since the direct borrowing by SNGs is restricted by the budget law, borrowing by off-budget vehicles creates a hidden market that lacks transparency, setting hurdles for the functioning of fiscal constraints and market discipline. The situation deteriorates under imperfect budget management and financial governance, which induce the potential expectation of a bailout. In this market, SNGs conduct debt financing without an effective regulatory mechanism, and investors make supply decisions without prudent considerations of risks. Thus, allowing direct borrowing by SNGs and market access by UDICs, under transparent and rule-based regulatory frameworks, would help make subnational debt finance in China more sustainable in the long run.

Concluding Remarks

China successfully established a new instrument of subnational bonds to finance subnational capital expenditure through the transition from direct central government onlending to market access. The reform was timely in meeting subnational needs to help finance the subnational matching part of investment projects in which the central government co-invested in response to the 2008–09 global financial crisis. In particular, recognizing that certain preconditions did not exist for direct market access by SNGs, China adopted a pragmatic and innovative approach by initiating the subnational bonds by the central issuance. The approach significantly lowered the financing costs for SNGs, enabled them to start acquiring market access skills, and linked the SNGs as debtors with their debt service obligations. Piloting municipal bonds, without the central government as the issuer, is an additional step for SNGs to directly assess the market, which would provide experience and lessons for further reforms.

Urbanization and industrialization will continue unabated, requiring continuing capital investments by SNGs in large-scale urban infrastructure to support sustained economic growth. Subnational debt instruments will continue to play a vital role in economic transformation. Although bank loans are currently the most important debt instrument, China already has the largest subnational bond market among developing countries, and the market is likely to continue to expand.

China has made important progress in institutional reforms and moving toward a more transparent fiscal framework. The reforms in fiscal management (including the single Treasury account and expenditure reforms) and in separating management from ownership of public enterprises have laid the groundwork for the piloting of provincial bonds. The new bond instrument to finance capital outlays under newly developed budgeting procedures will facilitate the development of a framework for medium-term capital budgeting for infrastructure investments. The audit of, and the ongoing efforts to better classify, UDIC debt would facilitate the development of different bond instruments with different risks and securitization profiles.

Continuing reforms need to address two main challenges. The first challenge is to transform direct lending from the central government to SNGs into SNG market borrowing. Issuing provincial bonds is a first step in that direction. Since the central government is the issuing agency, one challenge is to mitigate the potential bailout expectations of both the SNGs and investors in the long run. The second challenge is to develop regulatory frameworks for UDIC direct borrowing from the financial markets and managing the contingent fiscal risks from UDICs. Subnational governments may circumvent the regulations by issuing UDIC bonds. Reform options would include incorporating the liabilities of UDICs into subnational budgets, providing debt service provisions in the budget for UDICs that are not financially self-reliant, and disclosing contingent liabilities through financial statements as annexes to subnational government budgets.

In addition to developing regulatory frameworks for subnational debt—such as ex-ante rules regulating types and purposes of debt and procedures for issuing debt, and recourse for insolvent subnationals and UDICs—reforms in broader areas will support sustainable market access. These would include strengthening intergovernmental fiscal systems and public financial management, enhancing fiscal transparency, deepening financial sector market reform, and improving the efficiency of the government debt market (or, more broadly, fixed-income markets) and the capability of SNGs to manage their own issuance program. The success of subnational debt financing requires a strong institutional foundation in terms of subnational financial planning, budgeting, debt management, and a credit rating system.

China has the potential to accelerate subnational debt market development, while managing risks to the macroeconomic frameworks and financial system. China's strengths include (a) a stable macroeconomic framework, including an impressive growth record (economic growth is a key determinant of debt sustainability); (b) large domestic savings, which provide capital supply to the financial markets; (c) rapid urbanization, which can be facilitated by financial market long-term financing; (d) a decentralized fiscal structure; (e) infrastructure companies organized along infrastructure networks and the adoption of cost recovery goals, both of which are critical for developing a deep revenue bond market; and (f) a track record of reforms.

Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

1. The term *subnational* refers to all tiers of government below the central government. The category also includes special purpose vehicles or investment companies created by SNGs.
2. "Auditing Report 2010," No. 35, National Audit Office of the People's Republic of China.

3. SNGs have better information regarding their debt and may not have incentives to reveal that information.
4. The land-use-right transfer fee is a one-time payment made by land users to obtain urban land-use rights for a given period of time, usually about 70 years for residential use and 50 years for commercial use.
5. "Announcement on Issuance of 2009 Subnational Bonds, State Council" 2009, No. 2. These bonds are equivalent to general obligation bonds; that is, debt is secured by the general revenues of a province, including taxation and fiscal transfers.
6. "Announcement on the Experiment of 2011 Municipal Bonds Issuance," Ministry of Finance (Treasury) 2011, No. 141.
7. Loans from foreign governments or from international financial institutions. In accordance with regulations, on behalf of the Chinese government, the Ministry of Finance could take out a loan and give the proceeds to central agencies and SNGs for domestic expenditure.
8. Article 21 of the Road Law (1998) states that in raising funds for highway construction, the government at all levels may raise funds for highway construction, including collecting charges or seeking loans from domestic and foreign financial organizations or foreign governments according to law and relevant provisions of the State Council.
9. 1998 was the first time that China implemented the proactive fiscal policy. The State Council decided that the MOF should onlend a certain amount of external national debt to provincial jurisdictions to help finance construction projects in order to expand domestic demand and promote stable economic growth.
10. The investments included urban infrastructure, environmental protection, developing and upgrading urban and rural power grids, agriculture, forestry, water conservancy, and transportation.
11. The UDICs started in 1992. That year, to promote the development of Pudong New District in Shanghai, the Shanghai Chentou UDIC, with the permission of the central government, issued a bond for Pudong New District Construction in the amount of RMB 500 million.
12. "The Decision on the Reform of Investment System," State Council, No. 20, 2004.
13. The United States continues to be the largest subnational bond market. From 2007 to 2011, annual average issuance of total subnational bonds was about US$450 billion (*Source:* Thomson Reuters), and at the end of 2011, outstanding debt was US$3.743 trillion ("Flow of Funds Accounts, Flows and Outstandings," Federal Reserve Board, Fourth Quarter 2011).
14. "Auditing Report 2010," No. 35, National Audit Office of the People's Republic of China.
15. "Notice about Strengthening the Management of UDICs," (Document No.19), issued by the State Council on June 13, 2010.

16. For more on land asset-based financing, see Peterson and Kaganova (2010).
17. According to the China Index Academy, land-leasing contract revenues set a record in 2009, with Hangzhou (RMB 105.4 billion in contract revenues), Shanghai (RMB 104.3 billion in contract revenues), and Beijing (RMB 92.8 billion in contract revenues) leading the way. In Beijing's case, the land-leasing contract value in 2009 was equal to 45 percent of total fiscal revenue. (*Source:* Xinhua News Agency, February 5, 2010. See also Peterson and Kaganova 2010).
18. For example, for an entire new commercial and residential zone, or for a high-tech zone (see Peterson and Kaganova 2010).
19. This is often used during the high-growth period of urban development (see, for example, in France, in Peterson and Kaganova 2010). The expectation that land values will increase with urban growth has made land an attractive asset for loan collateral, both for public borrowers and private lenders.
20. The exchange rate at the time of writing of the RMB to the U.S. dollar was RMB 6.30 to US$1. The RMB has appreciated continuously since 2005, at about 3–5 percent per year.
21. See chapter 2 "Restructuring of Legacy Debt for Financing Rural Schools in China" by Liu and Qiao in this volume.
22. UDICs construct and maintain most transport infrastructure, with the exception of the rail network, which is the responsibility of the Ministry of Railways. (Data from the World Bank and Development Research Center of the State Council, the People's Republic of China, 2012; and Amos, Bullock, and Sondhi 2010).
23. In accordance with the relevant provisions of the state, the treasuries at various levels of government must manage promptly and accurately the collection, allocation, withholding, and turnover of budgetary revenues, and the appropriation of budgetary expenditures.
24. This facilitates the separation of the government function from the commercial function, so the public administration risks can be eliminated and the management of the public enterprise reflects commercial risks.
25. "Interim Regulations on Supervision and Management of State-owned Assets of Enterprises," State Council, No. 378, 2003.
26. The land-use-right transfer fee is a one-time payment made by land users for obtaining urban land-use rights for a period of time, usually about 70 years for residential use and 50 years for commercial use.
27. See Peterson and Kaganova 2010.
28. In the United States, subnational bond financing is subsidized through a federal income tax exemption.
29. For more, see Liu 2010.
30. See note 5.
31. National Development and Reform Commission, http://www.sdpc.gov.cn/xwzx/xwtt/t20090521_280383.htm (in Chinese).
32. The preparation included an international conference organized by the MOF in 2008 in Hangzhou and a set of policy research reports by the MOF on

international experience in managing subnational debt (see, for example, Li, Xu, and Li 2009; and Zhang et al. 2008).

33. "International Conference on the Development of Sound Secondary Market for Government Securities in China," February 2012, Beijing.
34. Including provinces, autonomous regions, four municipalities, and five specifically designated cities.
35. The bonds were named by the debtor governments specifically as "2009 government bond of XX province (xx batch)."
36. "Regulation of Budgetary Management of 2009 Subnational Bonds," MOF, 2009.
37. Such as the housing project for low-income families; rural livelihood projects and rural infrastructure; health care, education, and culture, and other social welfare infrastructure; ecological construction; earthquake recovery and reconstruction; and other projects related to people's livelihood.
38. "Regulation of Budgetary Management of 2009 Subnational Bonds," MOF, 2009.
39. The rules include the "Regulation of Budgetary Management of 2009 Subnational Bonds," "Regulations on the Issuance and Payment of 2009 Subnational Bonds Issued by the MOF on Behalf of SNGs," the "Financial Budget Accounting Regulations of the Subnational Bonds Issued by the MOF on Behalf of Subnational Governments," and "Management Regulations of Project Arrangements for 2009 Subnational Bond Funds."
40. Penalty interest = overdue payment × (coupon rate × 2 ÷ days in a year) × overdue days. Liquidated damages = overdue payment × (coupon rate × 2 ÷ days in a year) × overdue days.
41. The amounts issued to the eastern and western regions were reduced by RMB 1.2 billion and RMB 4 billion, respectively, and the amount allocated to the middle region was increased by RMB 5.2 billion, based on the adjusted capital investment plan.
42. "The Announcement of Insurance of Municipal Bonds," 2011, MOF.
43. Therefore, the municipal bonds issued by the four cities are similar to general obligation bonds. The UDIC bonds are secured by the revenues generated by the project or securitized by land assets; in reality, the lenders view the bonds as implicitly guaranteed by the government that owns the UDIC.
44. "State Council Directive on Management of Urban Development and Investment Corporations," No. 19, June 10, 2010.
45. *Source:* Ministry of Finance.
46. "Regulations on the Issuance and Payment of 2009 Subnational Bonds Issued by the MOF on Behalf of SNGs."
47. The leasing fees collected by SNGs for leasing land.
48. Real estate prices are rising for various reasons. On the one hand, the unprecedented scale of urbanization creates a rising demand for real estate, which causes property values to appreciate, giving SNGs a strong incentive to

participate in the land market. On the other hand, the fact that SNGs reap the benefit of land asset-based financing also contributes to the rising cost of housing, pushing the price higher and further strengthening the wealth effects.

49. In China, SNGs typically charge land users a transfer fee for 50-year usage for commercial development and 70-year usage for residential development.
50. For more on the issue of subnational fiscal autonomy and accountability, see Martinez-Vazquez and Qiao 2010.
51. Provincial governments receive 25 percent of value-added tax revenue and 40 percent of personal and corporate income tax revenue. Provincial governments decide the tax-sharing formula with their own subprovincial government units. The administration of shared taxes is centralized.
52. The fiscal expenditures of some less developed areas are concentrated on administration costs, especially on the expenses of local employees.
53. Based on an interview with an official in a local branch of the China Development Bank in 2010. The local branch has a risk analysis department that is separate from its lending activities, and one risk factor has been factored in during the lending decision—the total amount of UDIC debt in a local jurisdiction against the total revenues of that local government.
54. See World Bank and International Monetary Fund 2011.
55. Data for subnational debt are from "Auditing Report 2010," No. 35, National Audit Office of the People's Republic of China. Data for sovereign debt are from the *China Statistical Yearbook* (National Bureau of Statistics 2011).
56. Data for 2010 are from the *China Statistical Yearbook* (National Bureau of Statistics 2011). Data for 2011 are calculated by authors based on MOF data.

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The Philippines: Recent Developments in the Subnational Government Debt Markets

Lili Liu, Gilberto Llanto, and
John Petersen

Introduction

This chapter reviews access of Philippine subnational governments to the credit markets, impediments to such access, and recent developments in Philippine subnational finances. The Local Government Code of 1991 commenced decentralization and defined the structure of subnational government units in a unitary system. In this chapter, the term Local Government Unit (LGU) in the Philippines, used interchangeably with subnational governments, includes all tiers of the government under the central government.[1] Our findings have benefited from several recent reports that bear on the various issues covered in this chapter.[2]

In the Philippines, LGU borrowing is low compared to borrowing by subnational governments in many other countries. As will be discussed in the chapter, LGUs are carefully monitored by the central government both on their individual debt transactions, which are almost exclusively done with four Government Financial Institutions (GFIs),[3] and by regular reporting to the Philippine Department of Finance (DOF). There is no evidence that LGU borrowing has been used to cover operating deficits or to finance unusually large, speculative projects.

The LGUs appear to live under a "hard" budget constraint, and the sector as a whole typically runs a budget surplus. Part of the smaller appetite of LGUs for taking on debt has to do with the assignment of service responsibilities to the various levels of local governments. Most major infrastructure projects are controlled and funded at the national government level. Aside from a few major cities and the nation's capital region around Manila, there is a diffuse scattering of small and often rural governments that are highly reliant on transfers from the central government. In addition to the small scale and diffusion of local governments, there are also significant institutional and managerial barriers to their planning and managing major building projects.

Subnational governments in the Philippines were largely unaffected by the 2008–09 global financial crisis. LGUs, heavily reliant on national government transfers, felt little impact (they were more affected by two large tropical storms). While future national government payments to them will be slightly affected (the distribution formula has a three-year lag), the LGUs have continued to operate with an annual surplus.

Overall, local governments in the Philippines are light borrowers and appear to restrict lending to relatively small projects or to meeting occasional cash flow needs. By and large, the LGU sector has relatively small-scale and pedestrian (albeit individually important) capital financing needs. The low level of indebtedness is attributed to the limited functions assigned to LGUs that require infrastructure spending, the reluctance of local governments to borrow, and the impact of various financial oversight mechanisms. Some areas are changing, however, such as the use of project financing and restricting the security on loans to specific projects.

Notwithstanding a decade and a half of policy planning and innumerable reports, implementation has been slow in following through on an initial planning framework designed to move LGUs into private financing markets. Earlier, the Local Government Unit Guarantee Corporation (LGUGC) spearheaded the development of the LGU bond market. More recently, it has spurred Private Financial Institution (PFI) direct lending to LGUs, water districts, and electric cooperatives through the use of its guarantees. These efforts, while innovative, have not been mainstreamed in recent years. A main challenge has been the reluctance of GFIs and other government agencies to open the subnational credit market for LGU borrowing.

The basic question that remains is how to construct a financing framework to help LGUs attain "genuine and meaningful local autonomy to enable them to attain their fullest development as self-reliant communities and make them more effective partners in the attainment of national goals."[4] The DOF developed the LGU Financing Framework in 1996, which was later confirmed by the government.[5] The development of clear and consistent government policies to encourage competition in the subnational credit market will in the long term help the implementation of the framework.

Another key aspect in the deferral of implementation of policies lies in the very nature of the LGUs themselves. While there has been innovation in devising programs to foster the use of credit to support development, the local governments have been reluctant to borrow. This appears to be due in large part to a natural conservatism. Local governments appear to have little appetite for credit financing, with the exception of a relatively small number, which have tapped both loans and bonds to finance various local projects.[6]

On the one hand, this attitude has avoided fiscal difficulties that might have occurred as a result of profligacy. On the other hand, the cautiousness has stymied local development initiatives. According to the discussions within the country, next steps include bolstering LGU credit relationships with the private sector. However, the dominant role of GFIs in financing LGUs may limit the extent of the financing opportunities by the private sector.

The remainder of this chapter is structured as follows. Section two examines the structure and finances of subnational governments in the country, including the growth and patterns of local government spending and revenues, and presents a recent history of LGU borrowing and its levels of indebtedness and the regulatory framework for subnational unit borrowing. Section three analyzes a range of factors, including the legal borrowing limitations and the various financial oversight mechanisms that have led to low demand for debt instruments by subnational governments in the country. Section four reviews the development of subnational credit markets, the status of PFI lending, and the composition of debt instruments. Section five reviews recent innovation in the subnational credit market and analyzes prospects. Section six provides conclusions.

Subnational Government Finance and Borrowing Framework

The Philippines is a unitary state with a hierarchical system of governance. Subnational governments are part of the state and are directly under the control of the national government, though with certain constitutional protections. The subnational government sector consists of three levels: the provinces and major cities, the municipalities, and the *barangays* (neighborhood organizations). The country, with a population of approximately 90 million, has more than 1,700 local governments (not counting the 42,025 barangays), including 80 provinces, 138 cities, and 1,496 municipalities.[7]

The Local Government Code of 1991 was revolutionary in its impact on decentralization. It assigned greater responsibilities for service provision to subnational governments and also entitled them, under the Internal Revenue Allotment (IRA) scheme, to receive 40 percent of the national government's income and value added tax revenues, which are distributed on a formula basis. The Code also gave local governments expanded powers for setting local tax rates and collecting own-source revenues. The mainstays of local revenues are the property tax, the business tax, and taxes on vehicles.

The implementation of decentralization and the realization of what was envisioned in the Code have been slow. Two decades after enactment of the Code, the size of subnational governments measured by spending remains small. Total LGU spending increased from an average of 1.6 percent of Gross National Product (GNP) during 1985–91 to about 3 percent in the late 2000s.[8]

Local Government Spending and Revenues

Local governments allocate the biggest portion of their budgets to general public services, which are basically the general administration services needed for the daily routine of running a local government. Expenditure for economic services is the second-biggest expense. A review of local public expenditure management is needed to achieve more efficient allocation of resources. There appears to be relatively low investment in human capital (education, health, and nutrition) and in infrastructure relative to other expenditure items.[9] The central government and government-owned and government-controlled corporations continue to implement major infrastructure projects, but with greater emphasis on public-private partnerships (PPP) in infrastructure. Overall, LGU spending has averaged only around 3 percent of GNP. Table 11.1 presents a distribution of LGU expenditure.

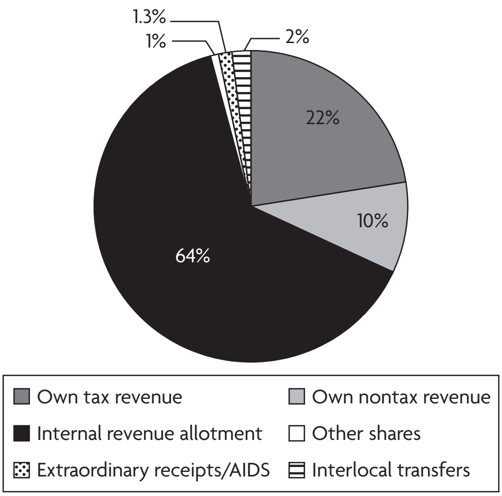
On the revenue side, subnational governments' own revenues accounted for about 32 percent of total revenues in 2009, and subnational governments are highly dependent on fiscal transfers from the central government. Figure 11.1 illustrates the percentage composition of sources of revenues of all local governments. There were no significant changes in the composition of sources of revenues in the 2000s. The fiscal transfers, principally the IRA, account for almost two-thirds of LGU revenues.

Table 11.1 Distribution of Total Expenditure, All Local Government Units, 2001–09

	2001	2002	2003	2004	2005	2006	2007	2008	2009
General public services	40.51	41.34	40.41	40.02	39.63	40.36	41.74	44.14	53.91
Education, culture, and sports/ manpower development	7.09	6.53	6.85	6.61	6.95	6.86	6.53	5.94	6.11
Health, nutrition, and population control	11.50	11.72	10.85	10.97	10.18	9.80	9.78	9.76	11.35
Labor and employment	0.16	0.15	0.12	0.06	0.07	0.07	0.07	0.06	0.07
Housing and community development	4.38	4.42	2.40	2.05	2.18	2.05	2.01	2.13	3.28
Social security/ social services and welfare	3.02	2.83	2.57	2.39	2.39	2.35	2.45	2.41	5.16
Economic services	18.55	16.74	15.76	15.76	15.75	15.04	15.22	15.09	18.55
Debt service	2.41	2.39	2.87	2.73	3.27	3.21	3.23	3.29	1.59
Other purposes	12.37	13.88	18.18	19.42	19.59	20.26	18.97	17.17	0.00
Expenditures	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Bureau of Local Government Finance.

Figure 11.1 Distribution of Total Income, All Local Government Units, 2009

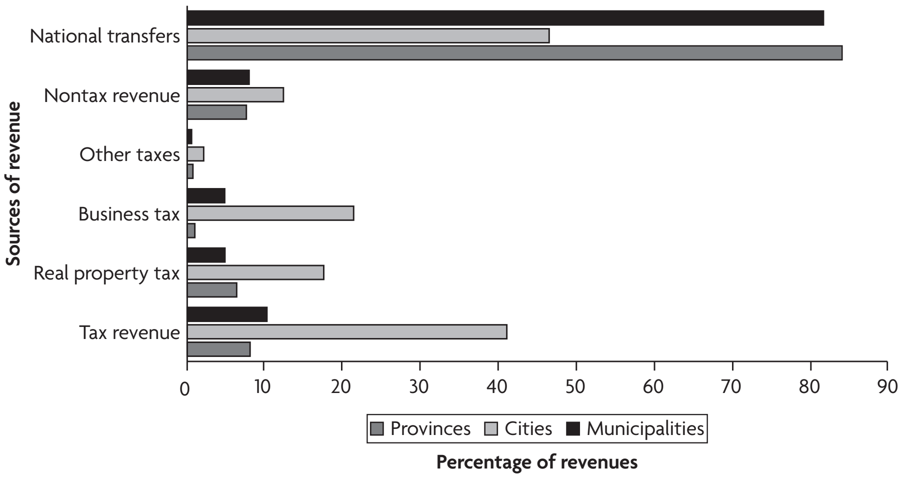


Source: Bureau of Local Government Finance.
Note: AIDS = national government assistance to local governments.

Figure 11.2 presents revenue sources across provinces, cities, and municipalities for 2009. As can be seen, the aggregate revenue numbers mask big differences among the categories of local jurisdictions. Cities derived about 40 percent of their revenues from their own revenue sources in 2009 compared with only about 8 percent for municipalities and 10 percent for provinces. The cities have larger tax bases and, consequently, enjoy more buoyant own-source revenue opportunities. However, most LGUs (that is, the provinces and municipalities) have narrower tax bases and thus do not raise proportionately as much own-source revenues. They have remained dependent on fiscal transfers, principally the IRA, for funding local development activities.[10]

The IRA program of the formula-based revenue sharing led to local governments largely substituting the new revenues from the central government for own-source revenues, especially the local property tax. Between 1990 and 1996, local own-source revenues declined from 50 percent of total local revenue to 30 percent, which is about the same today. The large vertical fiscal gap has been filled by IRA transfers, which comprised around 65 percent of total LGU incomes in 2009. The dependence on the IRA results in lesser local fiscal autonomy, which

Figure 11.2 Composition of Revenues by Type of Local Government Unit, 2009



Source: Bureau of Local Government Finance.

creates opportunities for greater control by the central government, contrary to the envisaged situation of local governments able to use own resources to respond to local needs and to match local outputs with local preferences.[11] In other countries, greater reliance on own-revenue generation has given subnational governments more fiscal autonomy. Granting subnational governments more revenue-raising power aims at creating a closer link between expenditure accountability and the use of revenues to finance such expenditure (Bird 2010).

Meanwhile, fueled by IRA payments, local governments' share of total government spending in the Philippines between 1990 and 1996 grew from 6 to 16 percent.[12] Thus, although their position as the final deliverer of public services grew, the local governments' relative share of direct spending remained small compared to that of the central government.

One motivation for the decentralized intergovernmental structure as reflected by the Code was to enable subnational governments to assume a greater share of the burden of financing infrastructure. It was thought that this might be accomplished by permitting subnational governments broad powers to borrow without the approval of the national government. To that end, the Philippine DOF, with considerable support from International Financial Institutions (IFIs), led the way on initiatives to expand local governments' access to credit, following a policy articulated in 1996.[13]

Although the Code grants subnational governments the general power to borrow, there are regulatory restrictions on borrowing activities. These restrictions are specified in the Code itself and also arise from regulations in the banking and financial sector. A brief synopsis of the major components of the regulation of local government borrowing and indebtedness, which is discussed in greater detail below, is provided in table 11.2.

Governments borrow for a variety of reasons. Generally, long-term borrowing for long-lived capital improvements is recognized as a legitimate use of debt as long as the indebtedness incurred aligns with a locality's ability (and ongoing willingness) to repay during the economic life of the capital investments. Borrowing to fund persistent shortfalls in current revenues (aside from unforeseen emergencies) is frowned upon.[14] Consistent application of this behavioral norm is an important element of a "hard" budget constraint.

The Local Government Code allows subnational governments to use credit financing for two purposes: liquidity and capital projects. Meeting liquidity needs involves credit financing of a local government's current spending in advance of expected releases of intergovernmental (primarily IRA) payments or the receipt of taxes. Borrowing by local

Table 11.2 Local Government Borrowing and Debt Limitations: The Philippines

Debt service ratio limit	Outstanding debt amount limit	Other restrictions
Debt service not to exceed 20 percent of "regular income," which includes intergovernmental payments. Of those payments, not more than 20 percent can be used for debt service. All LGU debt is effectively general obligation. Some water district borrowing (water) is based only on revenues.	None	• Bank loans for current and long-term investment needs; use of intercept of transfer payments as loan security (i.e., the central government fiscal transfers to LGUs can be used or intercepted for loan payments) • Bonds restricted to "self-supporting" (revenue-producing) investments • Bond issues subject to central government review for meeting debt guidelines • Localities must budget for committed debt service payments for their budgets to be valid.

Source: Petersen and Soriano 2008.
Note: LGU = Local Government Unit.

governments for liquidity has been modest, accounting for only 2 or 3 percent of their total annual receipts. However, subnational governments are not allowed by law to incur operating budget deficits and must appropriate in their annual budgets amounts sufficient to pay debt service for indebtedness incurred.[15]

The Local Government Code (Section 324) imposes a limit on subnational governments' borrowing capacity, stipulating that their appropriations for debt service (payments of interest and principal) should not exceed 20 percent of their "regular income" in any given year. Regular income is defined by the Bureau of Local Government Finance (BLGF) under the DOF, which certifies the debt service and debt capacity calculations, as the combined total of the three-year average of Locally Own Sources Income, the IRA payments estimated by the Department of Budget and Management, and the three-year average of national wealth payments. The total gives the "ARI" or "average regular income."[16] The (ARI) × (.20) equals the maximum allowable debt service ceiling.[17]

Given the high dependency of subnational governments on central transfers, what portion of revenues that can be pledged as security for debt service becomes important? A tighter definition is used with regard to the amount of IRA payments that can be pledged to debt service because of the widespread use of the IRA "intercept" (or a deposit offset) as a security on subnational loans. Only in the case of large cities does the distinction between "the regular income" and the IRA payment make a difference, since for municipalities and provinces, the IRA payments dominate the revenue stream.

As noted, regulation by the Code requires that a subnational government must budget for all its contractually due debt services; otherwise, its budget is considered void, and it cannot lawfully spend funds. Furthermore, the BLGF provides oversight of subnational government lending by calculating the required debt service.

Regulation of subnational bond issuance was indirectly implied by Section 296 of the Local Government Code, which subjected such debt to regulation by the Securities and Exchange Commission and the Bangko Sentral ng Pilipinas (central bank). However, at the outset of devolution after 1991, these regulatory provisions were not energetically exercised. Early on, the Securities and Exchange Commission held that local government bond issues were exempt from its registration procedures, but in late 2000, the DOF successfully requested the Commission to "delegate" its approval powers to it for purposes of developing a registration procedure.[18]

In addition, the New Central Bank Act (Republic Act 7653) requires that, as a condition of borrowing, the monetary board render an opinion on the impact of the borrowing on monetary aggregates, the price level, and the balance of payments. For a sovereign guarantee, there is a more rigorous test, and approval is required from the secretary of finance. No subnational government has borrowed with such a guarantee, nor has any borrowed in foreign currency.[19]

There is no formal subnational government insolvency system in the Philippines. The prevention of any potential defaults is through the screening (and de facto approval) of borrowings by the BLGF, and the GFI deposit offsets and intercepts fiscal flows to subnational governments. The intercept can be used directly only by the Municipal Development Fund Office (MDFO), which has not invoked it because subnational governments have proven to be good borrowers. The MDFO has worked closely with BLGF in tracking subnational borrowing capacity and debt service capacity, and has made good use of the information in screening subnational loan applicants. Government policy does not allow the direct use of the IRA intercept by government or private banks. However, all central government payments to subnational units are made via the Land Bank of the Philippines, which does employ assignments of IRA and deposit offset agreements to secure loans. Furthermore, subnational governments are required to keep deposits in the Land Bank and the Development Bank of the Philippines—both GFIs—except under special circumstances that require specific exceptions.

The global financial crisis of 2008–09 did not adversely affect the financial sector in the Philippines, much less the subnational governments. In general, domestic banks, investors, and subnational governments had no exposure to sophisticated financial instruments such as derivatives, although a few (domestic) commercial banks had negligible amounts in their investment portfolios. Instead, the Philippine subnational governments have maintained budget surpluses in general, with their revenues unaffected by international conditions (see table 11.3). All three levels of subnational governments have maintained budgetary surpluses. Overall, the Philippine economy runs a trade surplus,

Table 11.3 Local Government Finances: Key Ratios by Type of Unit, 2010

Type of Local Government Unit	Surplus as % revenue	Debt service as % revenue	Transfers as % revenue	Borrowings as % revenue	Total revenue (pesos millions)
Cities	13.4	1.3	41.3	5.2	126,763
Municipalities	11.7	0.8	78.4	2.1	99,270
Provinces	16.0	1.6	76.2	3.7	71,596
Overall	13.5	1.2	62.0	3.8	297,629

Source: Bureau of Local Government Finance.
Note: Borrowings = total receipts from loans and borrowings, debt service = debt service (interest expense and other charges), surplus = total revenue – (total current operating expenditure + total nonoperating expenditures), transfers = IRA + other shares from national tax collections, and total revenue = total current operating income + total nonincome receipts.

which is helped greatly by the growing level of international remittances from an estimated 8 million Filipino overseas workers. Philippine gross domestic product (GDP) continued to grow during the 2008–09 global recession. Philippine nominal GDP grew annually by 7.1 percent in 2007, 4.1 percent in 2008, and 1.1 percent in 2009. Subsequent growth in GDP was 7.5 percent in 2010 and 4 percent in 2011.[20]

Table 11.3, which is based on 2008 data, indicates that, with the exception of the cities, the smaller municipalities and the provinces are highly reliant on intergovernmental transfers (most of which consist of the IRA transfers). The LGU share of national internal revenue taxes was fixed by law at 40 percent of national internal revenues in the third year prior to the allocation year. However, the amount of IRA transfer varies over time, depending on the revenue effort of the central government. In 2009, a year after the financial crisis, the country's national revenue effort (measured as national revenues as a percentage of GDP) declined to 14.6 percent of GDP from 16.2 percent in 2008. In 2010, revenue effort further deteriorated to 14.1 percent. This means that the current IRA allocation was computed on the basis of central government collection of national internal revenues during the financial crisis year, which was a relatively bad year for revenue effort, with GDP growing at 1.1 percent in 2009. Thus, IRA payments are expected to decline somewhat—but, there has been a considerable lag.

Meanwhile, as discussed next, LGUs have surpluses to buffer the fluctuations in IRA payments. In addition, as seen in table 11.3, the level of LGU borrowing is negligible in proportion to receipts, and annual debt service requirements are just as low, equaling less than 3 percent of revenues in the aggregate. It needs to be noted that the actual surpluses are smaller than the reported "surpluses" in table 11.3 because, until 2011 when reforms were implemented, the government reporting systems did not capture expenditures from "continuing appropriations" that LGUs carry over from capital outlays that span more than one fiscal year.[21]

Table 11.4 provides a four-year display of the annual budget surpluses of subnational governments by type of unit. These have been steady among the various types of units.[22] As noted, the IRA payments to subnational governments are based on a three-year lag of national government revenues, which delays the impact of any national receipts on the IRA payments.

Central oversight of local unit debt is generally predicated on the nature of the market for such debt. Because there is a limited private market for Philippine LGU debt, there effectively has been de facto supervision of borrowing by the GFIs, which hold the vast majority of LGU debt. More formally, oversight is exercised by the BLGF through its review of the debt service ceiling and represents a de facto approval of borrowing.

LGU debt is monitored by the BLGF under the DOF. An agreement signed in 2002 requires that the GFIs, the central bank, and the LGUGC submit data on LGU debt to the BLGF. LGUs also provide data on debt and debt service through their Statement of Income and Expenditure, which they submit quarterly to the BLGF. The central bank also monitors GFI loans to LGUs and the purchases of LGU bonds.[23]

Table 11.4 Budget Surpluses of Local Government Units, 2005–08
billion pesos

Type of unit	2005	2006	2007	2008
Provinces	6.2	5.5	4.7	8.8
Cities	13.5	19.2	14.9	21.2
Municipalities	7.3	8.2	7.2	10.7
Total	27.0	32.9	26.8	40.7

Source: BLGF Statement of Income and Expenditure.
Note: After adjusting for the expenditures from "continuing appropriations," Local Government Unit annual surpluses ranged from half to one-third of the reported surpluses (see note 23).

Subnational Demand for Debt Instruments

The Philippine subnational debt is low compared to many other countries. The best way to make comparisons is to examine the level of debt as a percentage of the nation's GDP, since this takes into account the varying sizes of the underlying economy. The reported Philippine subnational debt is less than 1 percent of the national GDP. That ratio changes little by adding the indirect debt of subnational water utilities.[24] By comparison, the average ratio of subnational debt to GDP for developing and transitioning countries was 5 percent in the mid-2000s.[25] The low percentage suggests that Philippine subnational governments neither do much capital spending nor use much borrowing to finance those needs. Most capital spending appears to be for "development" purposes and is relatively small scale.[26] The contrast is even greater when compared to developed countries (the Organisation for Economic Co-operation and Development [OECD] nations). For the developed countries, the average subnational debt to GDP in 2006 was 6.7 percent.[27]

The disincentives for LGUs to contract debt for public infrastructure investments contribute to what seems to be a low demand by subnational governments for debt instruments in the Philippines.[28] The disincentives are mainly explained by the binding constraints that weaken the capacity of local governments to provide basic devolved services and drive economic growth.[29] The high level of fragmentation in the subnational government structure contributes to the lack of economies of scale in infrastructure provisions. The local government system comprises a large number of small jurisdictions at each level of subnational government. The fragmentation can be overcome by forming interjurisdictional cooperation in infrastructure provision.[30] However, there is a lack of noticeable pressure from local citizens for local governments to invest in better infrastructure and service delivery. The service delivery system is multitracked in almost all sectors. National government agencies continue to play major roles in the delivery and finance of local services, including using discretionary funds.

The current IRA formula does not compensate for the varying degrees of fiscal capacities of LGUs. In fact, the large IRA transfers from the central government have a disincentive effect on local tax efforts; LGUs that receive a larger IRA tend to be lax in their tax efforts.[31] Local officials have strong incentives to lobby for resources directly from the national government. A recent study shows that a model-based Good Governance Index is not strongly associated with election results.[32]

The poorer LGUs have a low fiscal capacity to leverage borrowing. Real property taxation potentially offers a revenue-rich tax base, but there are challenges to greater use of that source: land titling issues, lack of cadastral surveys, unwillingness of local assessors to update assessment levels, and resistance of the local propertied class to an increase in property taxes. Weak local economies give rise to low local business tax collections. As a result, the weaker, rural LGUs heavily depend on the IRA, the national government's fiscal transfer, to finance local development activities, and on the "pork barrel" of legislators for livelihood projects and the usual infrastructure projects such as farm-to-market roads, barangay halls, and others.

An ongoing national government project on improving land and property valuation seeks to provide LGUs with the tools for doing proper land valuation and assessment.[33] According to BLGF, many LGUs are starting to realize the great revenue potential arising from updated land values and better assessment practices. The project has led to the establishment of Philippine Valuation Standards, patterned after the international best practices on valuation, the development of IT (information technology) systems, and measures to support the formulation of a market-based schedule of property values.

The higher-income LGUs are experiencing pressure for better infrastructure and services, stemming from their transformation into growing urban centers. The growth of global business processing outsourced to Philippine-based companies and call centers, among others, is transforming the bigger LGUs, which are seeing the need for better local infrastructure, including more reliable and competitively priced electricity supply, and public service delivery. These higher-income LGUs borrow mostly from the GFIs, and receive a larger share of the IRA due to their larger population and land areas.[34]

The national government has adopted PPP as its main strategy for infrastructure provision at the national and local levels. The PPP approach is a potential source of demand for more debt financing at the local level if LGUs are to manage those PPP projects assigned to their mandate and the above-mentioned binding constraints to local service delivery relaxed.

Moreover, on the demand side, using PPP for infrastructure development at both the national and local government levels, encouraged by the government policy, will require the building of local capacities to deal with private sector investors and lenders under this mode of procurement.[35] LGU demand for borrowing, especially for infrastructure, is expected to increase. PPP for local infrastructure and an increase in LGU demand for borrowed funds for this purpose will require effective coordination with the national government, especially its oversight agencies and infrastructure agencies.[36] There is also the issue of how effective the PPP approach will be as an alternative for small-scale and non-revenue-producing projects.

Subnational Credit Market and Composition of Debt Instruments

The composition of Philippine subnational debt consists mainly of debt owed either to higher levels of government or debt in the form of loans from government-owned banks. Although development of the subnational bond market gained momentum in the late 1990s, subnational bonds have not become a main part of the debt portfolio.

Public Financial Institution Lending to LGUs

The Local Government Code of 1991 has the potential to open several avenues for local governments to access credit finance from bank credits and "other similar forms of credits," and also from bonds and "other securities." Notwithstanding the potential, lending by the GFIs continues to be almost exclusively the source of loan funds for subnational governments. Subnational governments naturally made initial credit requests to the GFIs, since the GFIs hold the cash accounts of LGUs. The main sources of domestic credit financing are two GFIs, the Land Bank and the Development Bank of the Philippines, and two specialized onlending institutions, the Local Water Utilities Administration (LWUA)[37] and the Municipal Development Fund (MDF), which is run by MDFO.[38] The LWUA channels development assistance to local water supply projects and has offered long-term loans that match those of the underlying development assistance loans.

In the early years after the Local Government Code was implemented, the Philippine National Bank, which was later privatized, and the Land Bank were the largest providers of credit to local governments. In 1995, the Philippine National Bank held about 6 billion pesos in loans to local governments and the Land Bank held about 5 billion pesos. The Development Bank of the Philippines was just starting to lend to local units. The MDF had about 2 billion pesos in loans and the LWUA had about 8 billion pesos in loans to the water sector.[39]

The GFIs, reopening their lending windows to local governments after the widespread defaults of the 1980s, focused on those with higher incomes, as evidenced by the large average loan size in their local government loan portfolios. Interest rates on these loans were about the same as those on their prime commercial loans, suggesting that they assigned a low-risk premium to local governments. The average tenures were longer than those for commercial loans, at about two to four years.

After 1995, the growth of lending rapidly accelerated for both the Land Bank and the Development Bank of the Philippines, in part because of the rapid withdrawal of the Philippine National Bank from the local government credit market following the bank's privatization.[40] Also, both the Land Bank and the Development Bank of the Philippines got access to foreign loans for relending to LGUs and enhanced their depository relationship with LGUs.

The GFIs have actively used the depository relationship and government reporting to create credit and investment instruments. They base lending decisions for capital projects on the IRA and revenue flows of the LGUs rather than on the revenue flows of the project. They make available short-term credit facilities tied to future budget releases that allow LGUs to draw funds in advance of revenues.[41] They also enable LGUs to arbitrage on interest rates and on financial reporting by, for example, granting loans secured on their deposits and allowing the local governments to earn spreads on their investments, while still reporting high deposit balances. These practices help the GFIs manage the risk of lending to LGUs, while enabling the LGUs, to venture into commercial borrowing and financing of capital projects.

The LWUA, which lends to the local water districts, suffered ongoing structural problems that prevented it from expanding its participation in financing local water supply projects. Lending by the MDFO also grew slowly, reaching 2.7 billion pesos in 1999 and 3.7 billion pesos in outstanding loans by the third quarter of 2010. Among other possible sources, the government pension funds, which had shown early interest, were content to invest in high-yield government obligations and made heavy commitments to the commercial property sector and equity investments. These factors impeded their participation in the local government credit market.

Table 11.5 summarizes the present structure of the Philippine local government debt market. Overall, with a relatively small domestic bond market, the provision of credit to LGUs in the Philippines is overwhelmingly done by the GFIs. The Philippines has a largely bank-dominated credit system. Generally, as financial systems mature, they tend to develop alternatives to the reliance on banks for credit. This usually entails the growth of savings-based institutions and various forms of insurance that have longer-term investment horizons. As will be discussed, the Philippines has a formal policy of promoting private sector financing of those LGUs that are higher income and that have self-supporting projects. However, notwithstanding earlier efforts to achieve that goal, the current state of affairs is a continuing dominance by the GFIs over LGU credit access, as shown in table 11.6.

Out of a total outstanding LGU debt of 68.02 billion pesos, as of September 10, 2010, about 86 percent was owed to GFIs, and 9 billion pesos, or 13 percent, was owed to two private banks, which by law

Table 11.5 Structure of Philippine Local Government Debt Markets

Institutions	Cost of borrowing	Debt instruments
Predominantly loans by government-owned banks. Also, some bond issues in capital market using bond insurance that also relies on transfer aid intercept provisions. Some special onlending funds.	Most interest rates at market levels. Government banks can use intercept/offset on intergovernmental transfers to secure loan repayments. Local governments usually must use government banks for deposits.	Bank loans and bonds of 7-to-10-years' maturity. Some subsidized onlending using donor funds for special purposes up to 15 years.

Source: Petersen and Soriano 2008.

Table 11.6 Outstanding Loans and Bonds of LGUs (as of September 10, 2010)

	Amount (billions pesos)	% of total
Loans from GFIs	58.29	85.69
Land Bank of the Philippines	43.25	63.59
Development Bank of the Philippines	3.26	4.79
MDFO	11.77	17.31
Loans from PFIs	8.94	13.15
Philippine National Bank[a]	3.67	5.39
Philippine Veterans Bank[b]	5.28	7.76
Bonds outstanding	0.79	1.16
LGU Guarantee Corporation	0.25	0.37
Philippine Veterans Bank[c]	0.54	0.79
Total	68.02	100

Source: Bureau of Local Government Finance.

Note: GFIs = Government Financial Institutions, LGU = Local Government Unit, MDFO = Municipal Development Fund Office, PFIs = Private Financial Institutions.

a. Formerly a GFI that, after its privatization, has retained the ability to hold LGU deposits.

b. A privately owned bank whose board of directors is appointed by the president, with ability to hold LGU deposits. Not shown is an estimated 20 billion pesos in LWUA loans outstanding to water districts.

c. This amount may include bank loans that are guaranteed by the Philippine Veterans Bank, as well as bonds.

(Philippine Veterans Bank) or by special authority from the Monetary Board (Philippine National Bank) are authorized to accept deposits from LGUs. It appears that just over 1 percent of LGU debt is owed to other PFIs, which are primarily banks that have bought the bonds issued by LGUs and guaranteed by the LGUGC or the Philippine Veterans Bank.

The Philippine debt service limit is similar to that found in many countries and is, perhaps, a little less generous than that found in others. Many countries place a maximum limit on debt service as a ratio to annual revenues or expenditures.[42] A few countries limit the amount of annual borrowings to a fraction of a government's total revenues (which may make sense in terms of short-term debt but is not rational when it comes to long-term debt). Overall, the limitation on general obligation borrowing (borrowing is secured by full faith and general revenues such as sales and property taxes of the local government) makes sense. But it does not address the case where an LGU might not pledge its "general revenues" to the repayment of the debt but relies on enterprise earnings or other "non-general" revenues, where borrowing is secured by specific revenues or self-sustaining revenue generated by the project that is being financed by the debt (this is addressed further, below).[43]

The statutory debt limit is not, however, the deterrence to LGU borrowing in the Philippines. Given the modest demands for loan funds by LGU borrowers, the debt limit is seldom reached. Generally speaking, for the LGU sector as a whole, it appears that total debt service payments, in the aggregate, are equal to only 2–3 percent of "regular" income (depending on how tightly that concept is defined). Furthermore, annual LGU borrowing equals only 2–3 percent of total LGU receipts (recently, 4–6 billion pesos in aggregate borrowing, compared to around 200 billion to 230 billion pesos in total revenues and receipts). According to the BLGF, there have been few cases of LGUs being near (or closely approaching) the debt service limit. Overall, the excellent repayment record of LGUs does not evidence any systematic fiscal strain or imprudence.

The debt capacity limitation, however, leaves one potential LGU borrowing opportunity unchartered. That is, while the debt limit makes perfect sense for those borrowings that are secured on general revenues (including the IRA), it does not contemplate the situation where an LGU might not want to borrow against its general revenues but rather against some specifically pledged revenues or assets. That would be a "revenue bond" or "limited obligation," in the parlance of the bond markets, where there is *not* a pledge of general revenues. Currently, there seems to be no explicit regulatory provision for that type of borrowing by LGUs. However, that approach is what the water districts in the Philippines are now using with their "water revenue loans" that are backed by pledged water revenues and "step-in-provisions" that allow the LWUA to take over operation in case of a default.[44]

BLGF has been recognizing "trust funds" in its tabulation of LGU accounts. The "trust fund" to conduct commercial operations within a government is a positive development. The other is the creation of "special districts" or "authorities" that have their own governing body, operate under a trust agreement (contract) with the lenders, and are insulated from the day-to-day budget and political issues of the LGUs. In these cases, either the record of existing operations or strong feasibility studies are needed. The role of the rating agencies is also often critical, since the ratings provide general benchmarks on the credit quality and debt marketability. Sometimes, there is general obligation support for debt service until the project becomes self-sustaining, at which time its obligations no longer count against the debt limitation.[45] However, as noted by Canuto and Liu (2010), without proper governance structure and financial transparency, the special district types of arrangement can carry fiscal risks and contingent liabilities to the government owners of such special districts.

The adoption of the special fund doctrine as a means of financing LGU capital needs will require legally enforceable contracts where the LGU (or a special fund or district created by it) will be required to run the project as a commercial enterprise and agree to do so with the creditors. Provisions will be needed to protect the investors in case the issuer or borrower defaults on its obligations. The current revolving lending program in the water district areas (which involves PFIs and does not rely on the IRA guarantee) needs to be carefully evaluated since such an evolving financing technique might have broader applications in the Philippines.

Private Credit and Capital Markets

LGUs have been able to access private credit markets but, until recently, only indirectly through bond issues, which have been purchased mostly by private banks and guaranteed by the LGUGC (or the Philippine Veterans Bank). Aside from isolated cases, there have been no direct PFI loans to LGUs. Most of the LGU bonds to date have had seven years' maturity, consistent with the short-to-medium-term nature of the banks' funds. However, LGU bond flotation has been infrequent since mid-2006. Direct lending by PFIs to LGUs has commenced, using loan insurance and liquidity facilities.[46] These deals are being done in conjunction with a new IFI-sponsored water revolving fund project. These new programs are aiming at getting PFIs to lend directly to LGUs. The LGUGC is currently packaging three such loans.

The PFIs are well aware that LGU lending and depository activities represent a profitable area for the GFIs; they would be anxious to compete if they could overcome the impediments. It is realized that the intercept on IRA payments (or some adaptation of it) is likely necessary to sustain the high repayment rates of the LGUs.[47] As noted, it has been difficult for PFIs to get an assignment of the IRA payments (which requires GFI involvement since they act as the LGUs' depository).[48] There are also continuing concerns about the ability and willingness of LGUs to pay on their debt, especially given the three-year election cycle. LGUs under the existing "IRA intercept/offset" enforced credit regime, however, have a nearly perfect record of paying their obligations to GFIs.

The Philippines received much international attention for its early efforts to build a municipal bond market, and its innovative use of bond insurance is accomplishing that deed. There was a flurry of activity in the issuance of municipal bonds in the late 1990s and early 2000s. This was made possible by the creation in 1997 of the LGUGC as a "private" insurer[49] of LGU loans and bonds. Between May 1999 and December 2010, the LGUGC guaranteed 19 bonds amounting to 3.25 billion pesos issued by 16 LGUs.[50] Projects financed include tourism-related infrastructure such as the Tagaytay City Convention Center and the Caticlan-Boracay Jetty Port. Public markets, commercial centers, public terminals, slaughterhouses, housing projects, a hospital, an academic center, a gymnasium, and an integrated solid waste management system have also been financed. Over 2.7 billion pesos of the LGUGC-guaranteed bonds had already been redeemed by December 2010, and it is estimated that only 590 million pesos of bond principal remained outstanding.[51]

However, insuring bonds was the first step taken by LGUGC and has not been the limit of its sphere of activity. By 2006, it began to insure bank loans, which did not entail the issuance of marketable bonds, but was geared to individual bank loans or syndicates of bank loans.[52] Over the last five years, this activity has increased, usually involving water districts and other public corporate borrowers. Table 11.7 presents LGUGC's overall activity through the end of 2010. As indicated, by the end of 2010, LGUGC's annual new insurance deals were running about 900 million pesos a year, and overall outstanding guarantees amounted to 2 billion pesos, of which an estimated 589 million pesos represented outstanding LGU bond issues.

The Philippine Veterans Bank also has guaranteed LGU bonds since 2003, amounting to 505 million pesos.[53] The bonds had a seven-year

Table 11.7 LGU and Other Entity Outstanding Debt (with LGUGC Guarantee), 2010, by Type of Unit

Type of LGU debt	Million pesos
LGU bonds	589
Water district loans	748
Municipal enterprise loans	151
LGU bank loans	518
Total	2,006

Source: LGUGC, December 31, 2010.
Note: LGU = Local Government Unit, LGUGC = Local Government Unit Guarantee Corporation.

maturity and a two-year grace period. However, most bonds had been fully redeemed, and by the end of 2009, the Philippine Veterans Bank had only approximately 100 million pesos in guaranteed bonds outstanding.

On a combined basis, the LGUGC and the Philippine Veterans Bank have guaranteed the issuances of LGU bonds amounting to 3.5 billion pesos, of which only about 500 million pesos (about 15 percent) remain outstanding. There have been no defaults, and early issues have been paid and retired. The rest were redeemed early, long before the end of the maturity period. Most of the redemptions were due to refinancing of the bonds via loans made by GFIs.[54]

When the LGUGC was started in the late 1990s, there was an initial flurry of bond issues and the hope that the bond market would "take off."[55] However, by the mid-2000s, the pace of bond sales slowed greatly. Private creditors were concerned that the GFIs were protective of their LGU business and sought to exclude others from lending to LGUs. The GFIs have a great informational advantage. Because of their holding of the LGU deposits, they are able to track the LGUs' financial activities and identify potential bond deals.[56]

In addition, the GFIs were reluctant to enter into assignments of IRAs and other LGU revenues to the PFIs engaged in lending to LGUs, and, in the view of LGUs, bond issues involve additional costs and administrative approval delays.[57] Such costs and delays can be avoided by seeking GFI lending that is secured by offsets to IRA transfers (which the LGUs were required to deposit in GFIs).[58] According to the PFIs, this requirement has created an uncompetitive situation in which the GFIs have strong advantages due to government regulation.[59] It is important to raise an even broader policy constraint for PFIs, which is the Monetary Board policy restricting PFIs from serving as depository banks for LGUs, except for special cases in which the Monetary Board issues a waiver allowing a specific LGU and PFI branch to engage in such a banking relationship. This is a fundamental barrier to direct PFI lending to LGUs.

Credit Ratings, Project Finance, and Debt Instruments

There continues to be a lack of timely and generally accessible financial information on LGUs and "independent" published ratings. The LGUGC publishes underlying ratings on the bonds it insures or is intending to insure. These information deficiencies have not been a major problem for the current GFI lenders, which took IRA payments as the primary security.[60] However, if the subnational capital market is to expand, the availability of operational data, well-prepared financial feasibility reports, and credit ratings would become important.

LGU loans receive the same treatment as commercial loans under the bank capital adequacy rules. However, municipal bonds sold with the LGUGC guarantee receive more favorable treatment.[61] The Agri-Agra capital requirements for bank investments continue to be a source of demand for holding LGU loans as assets, since they qualify in meeting the requirements.[62] It is reported that there is sizable demand by long-term investors for LGU bonds and loans.[63] In the past, some of the private bank trusts did come up against diversification limitations in the case of the LGU bonds.

There is also potential in long-term fixed-income demand from institutional investors such as life insurance, pension systems (public and private), and individual trusts. These investors have tended to invest in national government securities. Overall, however, the level of institutional financial investment in the country is not high. The national government has dominated the bond markets (over 95 percent of all bonds), and the growth has occurred most in the commercial paper area. However, the development of the fixed-income exchange by the Philippine Dealing & Exchange Corporation is changing that situation. This should increase liquidity and improve the demand for bonds in the Philippine market. The new exchange has developed a "yield curve" for government securities that can be used as a benchmark for other fixed-income obligations. However, LGU bonds can be listed on the exchange only if they are of sufficient volume.

There appears to be some headway on attracting PFI investment to the LGU sector. The Philippine Water Revolving Fund (PWRF) was established to mobilize private funds to the water sector and has qualified several PFIs to participate.[64] The Development Bank of the Philippines and PFIs can cofinance the loan with the LGUGC providing credit guarantee. The MDFO (in the case of LGUs) and the Development Bank of the Philippines (in the case of water districts) can make available a stand-by line of credit to refinance the PFI loan if the private lender decides not to extend the tenure beyond the current 10-year tenure. As of February 2011, five private commercial banks had loaned 1.069 billion pesos to nine water districts. Cofinanced loans amounting to 747 million pesos have been given to two water districts.

PFIs seem more comfortable with utility-type investments that are revenue producing.[65] For example, water district lending would appear to be favorable if the credit security issues can be resolved. Many water districts seem to be more professionally managed.[66] The election cycles may impact the behavior of local government officials, who may favor high visibility and fast-payoff projects.[67]

Overall, the PFIs are interested in authorities or districts that are insulated from day-to-day local administration and are professionally managed as enterprises. In such cases, debt issues are controlled by provisions in the underlying project and its loan contracts ("revenue bonds") and do not depend on general revenues (and the IRA payments).[68]

The development of new legal structures to support project financing deserves greater study, since there appears to be some headway already made in the formulation of LGU accounts. There is now recognition of LGUs having trust accounts that are not part of the regular annual budgetary appropriation, and which function as restricted accounts during the term of the trust. LGU economic operations that can be "ring-fenced"—in the sense that enterprise revenues must be dedicated to —payment for the enterprise's operations and debt repayment—are potentially feasible if there is a "special fund" doctrine.[69]

Extending loan maturity is important to finance long-term infrastructure assets. The Philippine bond and bank loan market, aside from the IFI funds that are usually provided for long-term maturity, is relatively short to medium term and, in the case of the PFIs, typically carry variable interest rates. Being restricted to the short maturities is a classic difficulty that subnational governments face in many emerging economies (and also in developed economies, especially when there is a substantial threat of inflation). Short maturities and variable rate structure prevent an erosion of asset value to lenders if interest rates rise rapidly.

The classic way to modify the terms of debt in the market under such conditions is to provide options that can protect both the lender and the borrower. In the case of lenders, they will want the ability to protect the value of their investment if interest rates increase. Borrowers, however, will want protection if interest rates decrease and, with a call option, they are permitted to refinance debt at lower interest rates.

These options were not used in the Philippine LGU financial markets until recently.[70]

Recent Innovations and Prospects in Credit Market Access

In the Philippines, fostering a competitive and diversified subnational credit market has been a long-standing policy goal.[71] It has also been in a protracted phase of experimentation. The private sector financial markets are playing a minor role in LGU financing, except in selective cases. Nonetheless, there are emerging opportunities for that activity to occur.

In the Philippines, as in many other countries, subnational government credit needs have been met for many years by bank loans. Various countries have moved toward a more competitive market structure with the participation of private creditors (Canuto and Liu 2010). Some countries, including the Philippines, have continued to rely mainly on GFI for subnational credit financing. In many cases, this approach was initially necessitated by weak domestic credit and capital markets. Also, local governments were subordinate in the political and economic structure and depended on the central government for guidance and support.

The Local Government Code of 1991 sought to significantly change the relationship of local governments to the central government. It sought to empower local governments to act with greater responsibility and autonomy and provided them with substantial transfers (the IRA payments) that now represent around 65 percent of all LGU revenues. The Code also provided LGUs with substantial powers to borrow. Meanwhile, the LGU financing framework was developed in 1996 to implement the credit-related dimensions of the LGU Code. It envisioned a combined effort by public and private financial entities to provide capital to the LGU sector. The GFIs were to be the lead entities in the case of the higher-income localities and self-supporting projects, and to gradually bring in private sector financial institutions.[72]

The overarching objective was to move local governments in the direction of sustainability and reliance on private market sources to the greatest degree possible.[73] A key role was assigned to the GFIs to act as a conveyor belt for those LGUs that are becoming financially stronger (or have stronger self-supporting projects), and helping them graduate into the private markets. This largely has not happened. The GFIs—because of their superior credit position, their ability to intercept LGU deposits, and their capacity in dealing with LGUs—have incentives to make loans to LGUs. The transition to PFI financing has been slow to materialize.

The development of competitive subnational credit markets will need to address both demand- and supply-side constraints. On the demand side, it is critical to strengthen the local finance and accountability systems for citizens to demand better services. As noted by section three, several factors contribute to the LGUs' low demand for debt instruments. These factors include a lack of pressure from citizens for better service delivery, difficulty in developing interjurisdictional cooperation in infrastructure provision to take advantage of economies of scale, inadequate debt and fiscal capacity, weak technical capacity to develop projects, and the available alternatives of accessing "pork barrel" projects from the national legislators. These factors collectively make the risks of borrowing by LGUs outweigh the potential rewards for LGU infrastructure investment and financing.

The higher-income LGUs are experiencing pressure for better infrastructure and services, stemming from their transformation into growing urban centers. They are likely to demand more debt instruments; thus, relaxing the binding constraints can help the higher-income LGUs become more viable borrowers. The national government has adopted PPPs as its main strategy for infrastructure provision at the national and local levels, which creates potential demand for more debt financing at the local level, particularly in major urban centers where the stronger fiscal capacity can make the PPP model more attractive to private players, including private financers. Developing strict sectoral financing policies will help reduce ad-hoc allocation of central government funds and reduce the incentives for LGU lobbying for the central discretionary resources.

In the Philippines, municipalities and lenders rely heavily on the IRA, in effect making all the municipal debt homogenized as a national credit. In the early state of developing municipal debt markets, debt issued based on fiscal transfers and central government guarantees may help start the market. But the continuing development of the market requires the use of financing instruments that rely more on own-source revenues and credit differentiations among LGUs. There are financing instruments that can forge closer links between own revenue of local governments and their capacity to access the market, which in turn help strengthen local accountability.

Revenue bonds have been used extensively in various countries, including the United States, as a powerful instrument to finance subnational infrastructure by linking project finance with benefit taxation.[74] The debt service is secured by revenue streams produced by the project financed by the bond instrument. The recent innovation in the water districts in the Philippines has indicated a similar direction—the water districts in the Philippines are securing their “water revenue loans” by pledged water revenues and “step-in-provisions.” The water districts legally exist outside the LGU accounts and act as separate government-owned-and-controlled corporations. The water district design might be adapted into a broader notion of economic development and/or infrastructure districts that would have a degree of insulation from the day-to-day administration of the LGUs.

Another often used instrument—tax increment financing—also helps link LGUs’ own revenue with infrastructure financing. The instrument is used for financing infrastructure and other community-improvement projects in many countries, including the United States.

Tax increment financing uses future gains in taxes to finance current improvements, which are projected to create the conditions for future gains. The completion of an infrastructure project such as power and water often results in an increase in the value of surrounding real estate, which generates additional tax revenue.[75] Tax increment financing dedicates tax increments within a certain defined district to finance the debt that is issued to pay for the project. It creates funding for public or private projects by borrowing against the future increase in these property-tax revenues.

Opening up the subnational credit market to private competition helps lower the financing cost. Attracting PFI investment to the LGU sector has recently gained headway in the Philippines. The PWRD was established with the participation of both public and PFIs to cofinance loans to water districts and LGUs. An important aspect of the subnational credit market is the competition among debt instruments. The private (corporate) bond market is small in many developing countries, and it remains small in the Philippines. Yet, properly secured, infrastructure financing would appear to be an ideal use of long-term bond issues. There is also potential in long-term fixed-income demand from institutional investors such as life insurance, pension systems (public and private), and individual trusts.

Conclusion: Constraints and Opportunities in the Philippines

The Philippines represents an emerging economy that continues to chart its own unique course when it comes to developing its subnational debt markets. The Philippines has been innovative in its efforts to extend the legal possibilities for local governments to take initiative in the use of credit and in the design of credit market techniques to make this possible. The Local Government Code, with its broad array of borrowing powers granted to LGUs, and the creation of the LGUGC insurance company to bolster local credits, are pioneering efforts.

Nonetheless, while a few urban and sophisticated Philippine local governments have been able to take advantage of these initiatives, many of the country's LGUs remain passive in their efforts to move ahead and proactively use the new powers to improve their condition.

There are binding constraints that weaken the capacity of LGUs for better infrastructure service delivery. The constraints relate to the local finance and accountability systems. As has been noted, this low level of accessing the debt markets has averted serious fiscal problems for local governments, but it has also resulted in limited local initiatives to promote economic growth.

Fostering competitive subnational credit markets has been a longstanding policy goal in the Philippines. Notwithstanding the Philippines's efforts to develop more diversified subnational credit markets, the transition to PFI financing has been slow to materialize, and the GFIs continue to be the main lenders to LGUs. The development of competitive subnational credit markets will need to address both demand- and supply-side constraints. On the demand side, it is critical to strengthen the local finance and accountability systems for citizens to demand better services. On the supply side, removing constraints to private participation in the market will increase competition and help lower the cost of financing. It is also helpful to experiment with those financing instruments that can forge closer links between own revenue of local governments and their capacity to access the market, which in turn help strengthen local accountability. The recent experiments of encouraging greater partnerships between the local governments and the private sector credit markets could pave the way for a more competitive and diversified subnational credit market.

Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

1. The terms *subnational government* and *local government* are used interchangeably in this chapter. While the country's legal framework for decentralization is reflected in the Local Government Code of 1991, the term *subnational government* is used to maintain consistency with usage in other chapters in this book volume.
2. Studies consulted include the following: ARD Inc. (2000), ARD Government Finance Group (2001), Janet Tay Consultants (2007), Llanto (2007), Pellegrini and Soriano (2002, 2006), and World Bank and Asian Development Bank (2005).

3. The government financial institutions mainly consist of the Development Bank of the Philippines and the Land Bank of the Philippines and two specialized onlending institutions: the Local Water Utilities Administration and the Municipal Development Fund. Section four provides details on government financial institutions.
4. In "Declaration of Policy," Section 2, Chapter 1, Title One, Book I of Republic Act No. 7160, the Local Government Code of 1991.
5. World Bank and Asian Development Bank 2005.
6. Llanto 2011.
7. As of March 31, 2012. Data from the National Statistical Coordination Board, National Economic and Development Authority.
8. Manasan (2005) and authors' calculations.
9. Llanto 2011.
10. Llanto 2011.
11. Llanto 2011.
12. Petersen 2004, 463.
13. Llanto et al. 1998.
14. The borrowing for long-term capital investment is called the "Golden Rule." Liu and Waibel (2008) review how various developing countries have adopted the Golden Rule in regulating their subnational debt financing, as part of their regulatory reform in managing subnational finance.
15. Section 303 of the Local Government Code of 1991.
16. Very little appears to be left out of revenues, except extraordinary items and, perhaps, some national grants. The IRA and national wealth payments make up 98 percent of all national payments. No local own-sources seem to be included (except for extraordinary items). For practical purposes, it appears that about 99 percent of all own-source and national-source revenues are included.
17. To calculate the net remaining debt ceiling, from that maximum amount is subtracted the annual debt service (which is called "amortization") on existing debt. To calculate "borrowing capacity," the net remaining debt ceiling is multiplied by an annuity factor that corresponds with the maturity terms of the principal repayments and the interest rate on the proposed debt. In other words, the debt capacity certification looks at the particulars of the proposed loan or bond issuance to see whether, *after* the borrowing is consummated, there is remaining debt capacity.
18. Petersen 2004, 464.
19. As a policy, DOF will not issue a sovereign guarantee for an LGU loan directly sourced from a foreign lender, including multilateral institutions.
20. See National Economic and Development Authority (Philippines), 2011 http://www.neda.gov.ph/econreports_dbs/NIA/GNP_GDP.
21. For example, an LGU that is unable to fully complete a capital investment project in a given year can carry over the remaining appropriation to the following year and complete the expenditures then. However, the official reporting systems

prior to 2011 did not capture these expenditures from "continuing appropriations," hence, resulting in underreported expenditures and overreported surpluses. A recent LGU data analysis done by the World Bank estimated that the aggregated annual LGU surpluses after adjusting for the expenditures from "continuing appropriations" range from half to one-third of what had been reported.

22. Unfortunately, BLGF does not provide balance sheet information. Also note that borrowing receipts are reported as "income," which is technically incorrect. However, adjustments to the local government income numbers in the aggregate have little impact on the revenue figures because of the low level of borrowing.
23. In that regard, the Bangko Sentral ng Pilipinas has asked the BLGF to review projects to be financed by LGU bonds. However, the BLGF, aside from doing the basic debt burden and capacity measures, does not appear to employ such technical capability at present.
24. The direct debt figure is a bit low because it does not include outstanding debt of water districts or local water utilities, which is considered as indirect debt of subnational governments. Water utility debt amounted to about 17.7 billion pesos as of end-December 2007. However, even if the number were twice as large, the percentage of GDP would still be only slightly over 1 percent. As of end-December 2009, LGU debt as reported by BLGF was 70 billion pesos. There was another 21 billion pesos in loans made to the water districts by Local Water Utilities Administration.
25. Petersen and Soriano 2008. The sample comprised 20 emerging and transitioning countries and their estimated subnational debt as of 2006.
26. An interesting contrast is provided by China, where urban development and finance corporations owned by subnational governments borrow from financial markets to finance mainly infrastructure investments. There are varying estimates of the size of subnational debt in China, averaging around 16 percent of GDP (Liu 2010).
27. The United States, with its federal system, provides a contrast to most other countries. Combined debt of the subnational governments equaled about 20 percent of GDP (U.S. Federal Reserve System, *Flow of Funds*). In the United States, the vast majority of public services are assigned to the subnational (state and local) governments, and most basic infrastructure facilities (airports, education facilities, highways, ports, sanitation, sewerage, and water) are owned and operated by subnational governments. Private sector provision of infrastructure is dominant in the electricity sector and telecommunications. Overall, state and locally owned facilities represent about 60 percent of ownership, and the private sector represents about 40 percent (see Petersen and Vu 2011, 4).
28. Unless otherwise noted, this section draws mainly from a World Bank mission conducted during January–February 2011.
29. The analysis of the binding constraints draws from the World Bank (2010), which provides a more detailed analysis of these constraints.

30. The examples can be found in the special vehicle arraignments in the United States (see for example chapter 14 by Liu, Tian, and Wallis in this volume), and intermunicipal cooperation arrangements in France covering a range of services such as water supply, household waste collection, and sewerage. France has a large number of small municipalities (see chapter 6 by Liu, Gaillard, and Waibel in this volume).
31. See Manasan 2007.
32. See Virola et al. (2007), whose study used 2004 and 2007 gubernatorial elections data.
33. Under the Land Administration and Management Project Phase II of the World Bank-AusAID. DOF has a property valuation office, which is spearheading efforts to assist interested LGUs with proper land valuation and assessment policies and techniques. The DOF Property Valuation Office will be superseded by a National Valuation Authority under a bill sponsored by the government creating the Authority, if it is voted into law by the Congress.
34. These higher-income LGUs receive a larger share of the IRA, but the share of IRA in their total revenues is smaller than the lower-income LGUs, as noted in section two, mainly due to the greater capacity of higher-income LGUs to raise own revenues.
35. LGUs are reportedly reluctant to undertake large infrastructure projects with the private sector, partly due to their lack of experience in working with the private sector on such projects.
36. The central government departments and agencies include the Department of Public Works and Highways, the Department of Transportation and Communications, and regulatory bodies such as the Toll Regulatory Board, and the Energy Regulatory Commission.
37. LGUs would first have to organize a water district. LWUA was established to lend to water districts.
38. The Municipal Development Fund is not a GFI per se but is lumped with the Land Bank and the Development Bank of the Philippines to form the three biggest government lending institutions providing loans to LGUs. Technically, MDFO is a bureau of the Department of Finance and is not a "free-standing" GFI institution. All GFIs and MDFO are subject to DOF oversight.
39. Llanto et al. 1998, 4. At an exchange rate of 50 pesos per US$1 (in 1995).
40. To this day, the exact status of the Philippine National Bank seems uncertain. While the bank has private ownership, it is still listed as a GFI by the Department of Finance for purposes of dealing with the LGUs (see "Department of Finance Annual Report" 2010).
41. It is estimated that about 80 percent of lending to LGUs is for capital projects and the other 20 percent is for cash flow purposes (borrowing in anticipation of collections of taxes or aid payments).
42. For a review of fiscal rules with respect to debt service limits, see Liu and Waibel (2008).

43. International statistics vary on the definitions. Generally, the U.S. numbers for subnational units include both limited and unlimited obligations as local debt. The other OECD countries usually do not count locally owned enterprises that are self-sustaining as local government debt, and the limitation caps do not cover that debt. Practices vary and this can lead to some of the differences in local debt numbers.
44. Discussions with Philippine bankers over the years indicate cautious interest in lending to LGUs without resorting to the IRA pledge. For example, a self-financing project could "pay for itself" without using up the borrowing capacity of the LGU. This can be done through the use of a "trust fund" that would have assigned revenues, such as from an enterprise's operations. (This is called the "special fund doctrine" in the United States and is the basis of the "revenue bond" structure.) Typically, debt limitations do not apply to this form of debt, which is viewed as "commercial," although carried out by a government unit. That is true in the United States and in the European Union. The test for issuance is purely a market test: Will investors feel secure in holding the debt, given the security that is pledged? They have no recourse to general revenues. Not surprisingly, there are many bonds that are "mixtures." In the case of a loan default, we understand that the LWUA has a "step-in provision" that it will operate the utility instead of the defaulting water district.
45. These obligations are called "double-barreled bonds" since they are revenue bonds when they are self-supporting but can become general obligations when they are not self-sustaining. The general practice is to not count them against debt limitations when they are self-sustaining.
46. A large private commercial bank has total LGU loan approvals of around 322 million pesos, up from 61 million pesos in 2007, without the benefit of a depository relationship with LGUs. It lends only to 1st and 2nd class LGUs under a loan guarantee provided by the LGUGC, and further secured by a deed of assignment of the IRA that is signed by the LGU borrower. At present, the LGUGC has given a loan guarantee of 3 billion pesos to LGU loans of this commercial bank. Only the MDFO is allowed to use the IRA intercept before IRAs (or other national government payments) are deposited. When it comes to GFIs and the private banks, the loan security is the deposit accounts of the LGUs. Those deposits consist of the IRA, own-source revenues, and other LGU receipts. More accurately, banks can seize those deposits, but not the IRA funds, per se. This is formally known as a right of offset, where the banks can make up any shortfall in the loan payments.
47. The repayment rate on LGU loans is high—about 98 percent. This level of repayment is also enjoyed by the MDFO, which has a full-fledged intercept (as opposed to the offset privilege used by the GFIs).
48. GFI loan officers are reportedly under pressure to keep their LGU clients.
49. At its inception, 51 percent of the LGUGC was owned by the Bankers Association of the Philippines and 49 percent by the Development Bank of the Philippines. In 2002, the Asian Development Bank bought a 25 percent ownership.

50. Caloocan City issued three bonds amounting to 620 million pesos on December 5, 2000. The 185 million pesos in bonds sold for a public market was fully redeemed by May 14, 2003.
51. LCUCG records as of December 2010.
52. As a matter of policy, the LGUGC will insure 100 percent of the debt service payments on bonds. It will insure only up to 85 percent of the debt service on insured bank loans.
53. From 2003 to 2006, several cities issued bonds backed by the Philippine Veterans Bank. These cities included Batangas, Masbate, and Tacloban. The bonds financed, among other things, a fishing port, a cold storage facility, a public market, and a transport terminal.
54. There were some timing factors. Interest rates in the Philippines fell rapidly in the mid-2000s, which allowed the GFIs to refinance the earlier municipal bond deals. However, it was believed by PFI market participants that the refinancing done by the GFIs on attractive terms was intended to deter market entry.
55. The 200-million-peso bond flotation of Cagayan Province for the construction of a commercial center in Tuguegarao City was guaranteed by a private insurance company, with a sister company acting as trustee bank.
56. The GFIs have extensive branches (particularly the Land Bank). About 65 percent of all Land Bank deposits are those of governmental units, including the LGUs. The Land Bank has a central role in the payments mechanism: it acts as the paying agent for all national government transfers to the LGUs, so the vast bulk of payments (including IRAs) are made through its accounts.
57. Bonds and loans require approval by the local *sanggunian* (municipal councils). However, bond issues must also be reviewed by the Philippine central bank.
58. Other program lenders have noted that the use of the IRA offset against debt service (popularly known as the intercept) discourages LGU borrowing from other programs that required meeting various program requirements. Historically, the costs of bond issues have typically ranged from 3 to 5 percent of the bond size, including the LGUGC insurance premium of 1–2 percent. See Exhibit C of Appendix E.1 of ARD (2001).
59. In the case of IFI loans, the national government imposes a surcharge of 4 percent on top of the IFI Libor-based loan rate. When the Libor is 4 percent, then the all-in IFI loan rate is 8 percent for the GFI. To this rate, the GFI may add a markup of 3 or 4 percent, which means a loan rate of 11–12 percent to the LGU. That rate might be compared to a conventional market rate (say, on long-term mortgages). But, as is recounted in this report, the GFIs are the main lender to LGUs and have LGU deposits and can use the "intercept" to back up their loans. Thus, from a credit perspective, the intercepted-reinforced LGU loan is virtually riskless and close to the credit quality of the national government's own obligations, although they are clearly not as liquid.

60. The Land Bank has its own internal rating system for LGU borrowers, which is proprietary. The LGUGC screen ratings (which are an overall guide and not attached to a particular loan) are public information.
61. The LGUGC is attempting to get its insured loans made to LGUs and water districts (as opposed to its insured bonds) also eligible for the favorable Agri-Agra treatment.
62. The Agri-Agra requirements are much like community investment requirements in the United States that are aimed at encouraging bank investment in local businesses.
63. Based on January 2011 field interviews with a number of private financial institutions.
64. The Japan Bank for International Cooperation, the United States Agency for International Development, the Development Bank of the Philippines, MDFO, and LGUGC worked together and established the PWRF.
65. This recognizes that some LGU-sponsored projects may not involve the pledge of IRAs (or other general tax receipts) but would be secured solely on project earnings. Recent loans involving water districts evidently carry this "limited recourse" provision, where the reserves and income accounts are pledged by assignment to the repayment of debt.
66. The management of water districts is overseen by a board of directors, who serve overlapping six-year terms. Directors can only be removed for "cause" and do not serve "at the pleasure" of the mayor or governor. As a practical matter, the water districts are generally insulated from the day-to-day politics of the LGUs.
67. This lack of repute among investors (no matter what the credit record) could be an argument for intermediation such as a bond bank, where individual "names" are submerged into the portfolios.
68. The security can be provided through the loan contract by empowering LWUA to take over the operation if there is a default (the step-in provision). This is already the practice—the step-in provision is in the agreements with water districts.
69. The special fund doctrine means that the revenues in the funds are dedicated to a particular purpose and cannot be used for other purposes. In revenue-bond transactions, the operation of the fund is restricted and carried out in accordance with the loan contract (an indenture). Such funds can be subsidized by general funds but can only transfer revenues to the general fund as is consistent with the contract. Often, the indenture is closed, meaning that all revenues and any surpluses must go to retiring debt. An alternative is to create the fund as a separate legal entity (a special district). The water districts in the Philippines are separate corporations and provide a model for that approach.
70. Water district financing under the revolving fund will have a put option for PFI banks. Evidently, at five to seven years, private banks can exercise a put option, which obliges the Development Bank of the Philippines or MDFO to absorb or "buy back" the loan. LGUGC is providing the insurance "wrapper."

71. See, for example, ARD Government Finance Group (2001), Chapter 6.
72. This included the use of BOT (build-operate-transfer)-type financing and the use of municipal bonds. The lower-income LGUs and more social or environment-oriented projects would be supported by the MDFO, as it was then called, with an emphasis on long-term loans, matching grants, and technical assistance.
73. See Appendix 1-A in Pellegrini and Soriano (2002).
74. For the development of revenue bonds in the United States, see chapter 14 by Liu, Tian, and Wallis in this volume. The adoption of the special fund doctrine as a means of financing LGU capital needs will require a regulatory framework that establishes financial rules, enforces contracts, and ensures transparency and disclosure.
75. Sales-tax revenue may also increase, and jobs may be added, although these factors and their multipliers usually do not influence the structure of the tax incremental financing.

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12

Russian Federation: Development of Public Finances and Subnational Debt Markets

Galina Kurlyandskaya

Introduction

Since the formation of the modern Russian state in 1991, the development of the subnational debt market in the Russian Federation has gone through three distinct phases: the 1990s, 2000–08, and 2008 onward. How and why subnational governments (SNGs) accessed the financial markets throughout the three phases has been substantially shaped by the evolving macroeconomic conditions in Russia and the development of an intergovernmental fiscal system since 1991.

During the first phase, the 1990s, the system of intergovernmental relations was highly centralized. The central government controlled subnational spending standards and norms, set prices for housing and utilities services, regulated wages of government employees, and arbitrarily determined the shared taxes assigned to each region. Intergovernmental fiscal transfers were negotiated between the federal Ministry of Finance and regional governments. During this period, Russia went through an unstable and uncertain macroeconomic situation in the early 1990s, followed by stabilization from 1992 to 1997. But the high fiscal deficit of the federal government and extensive use of internal and external borrowing to cover budget deficits contributed to the accumulation of federal government debt. This was followed by growing federal debt, financial crisis, and federal default on debt obligations in the late 1990s.

It is within this context in the 1990s that the subnational debt market began its early development and reached its peak in capital market development in 1997, and was then followed by defaults by most regional governments during 1998–2000. The growing demand on SNGs, unfunded federal mandates, and political decentralization contributed to the growing demand for debt instruments by SNGs. At the same time, there was a complete lack of debt regulation, and SNGs contracted debt through informal negotiations with the federal government. SNGs also lacked experience and capacity in managing debt risks. Debt was issued to finance recurrent expenditures, mostly with short-term maturities. With a rapidly deteriorating macroeconomic environment in Russia in the late 1990s, refinancing risks facing SNGs rapidly rose, and the federal government, with its own macroeconomic woes, was not in a position to provide support to SNGs. Fifty-seven of 89 regions defaulted on their debt from 1998 to 2000.

The subnational debt market entered its second period of development in 2000, and its development up to 2008 was helped by macroeconomic stabilization and success in Russia. Improved macroeconomic fundamentals contributed to positive changes in intergovernmental relations and incentives for new principles of financial management for the regions and municipalities. Gradually, financial capabilities of the Russian regions began to improve. Substantial legislative reforms—significant amendments to the Tax Code and the adoption of the Budget Code—were undertaken, aimed at the creation of a new formula-based system of relations among the tiers of government to replace the outdated, nontransparent, and informal arrangements. The 2006 legislation on local self-government established a uniform two-tier system of local self-government. Since the second half of the 2000s, the federal government has been paying more attention to the quality of public finance management in the regions and municipalities, which, in the long term, underpins the access by SNGs to market-based financing.

The Budget Code regulates subnational debt. Specifically, it specifies (a) sources for budget deficit financing; (b) limits on the size of fiscal deficit, debt, and debt service; (c) regulations on external borrowing and on guarantees; and (d) sources of deficit financing and structure and types of debt instruments. In addition, the Budget Code, and especially the 2007 amendments, regulates the system of granting federal, regional, and municipal guarantees. The Budget Code also establishes the structure of regional and municipal debt, its types, and maturity. Favorable terms of international trade and successful domestic economic development in Russia, especially between 2004 and 2008, have largely neutralized some negative aspects of the reform of intergovernmental fiscal relations for some of the Russian regions and municipalities. Their financial positions have strengthened considerably, together with revenue growth.

The debt load of the Russian regions remained low at the end of 2007. The regional debt was unevenly distributed across regions; five large regions accounted for about half of regional debt. Another feature of the debt of Russian regions was its short-term character. Short-term bank loans were a major debt instrument for most Russian regions. The majority of SNGs had little experience in debt management and had only short credit histories. During 2000–08, regions and municipalities showed increasing interest in obtaining credit ratings from rating agencies. Access to capital markets, however, is limited to the most creditworthy SNGs.

The global financial crisis of 2008–09 severely struck Russian public finances in 2009, though the impact varied across regions and municipalities. The strong regions that relied on their own tax capacity or exports were among the most severely affected, while the regions with a greater dependence on federal transfers appeared to be less affected. Bank loans and federal government loans became the main debt instruments of SNGs. The major problem for the Russian regions was not the absolute size of a debt load, but its payment structure. Reduced debt maturity terms created a substantial risk for refinancing and high debt service costs—factors that put pressure on their budgets.

A key difference between the 1998 and 2008–09 crises was the lack of defaults of regions on their debt obligations during the latter, owing to additional support from the federal government and the liquidity accumulated during previous years by the regions. Nonmarket instruments for financing the deficit of subnational budgets predominated in 2010.

Since 2011, subnational fiscal positions have improved, and the Russian economy has gradually recovered. The debt markets have recovered, and borrowing costs have been reduced. But activity in the domestic bond market remained moderate until 2011, when the market expanded. The debt repayment profile continued to be short due to the large share of short-term bank loans in the debt structure.

This chapter analyzes the development of the subnational debt market in Russia over the last 20 years, and shows how subnational debt market development is influenced and shaped by key macroeconomic developments and the evolving structure of the intergovernmental fiscal system. The chapter is organized as follows: section two describes the development of the subnational bond market from birth to expansion and from crisis to recovery over the 10-year period, 1991–2000. Section three summarizes key reforms in the intergovernmental fiscal system from 2000 to 2008 and how they have shaped the regulatory framework for subnational debt borrowing. Section four discusses the impact of the 2008–09 global financial crisis on subnational fiscal performance and subnational access to borrowing. Section five concludes with remarks on the challenges to the continuing development of the subnational debt market in Russia.

The Subnational Bond Market in Russia: Birth, Expansion, Crisis, and Recovery, 1991–2000

The formation of the modern Russian state began in 1991. The new state inherited its federal structure from the Soviet Union. The current structure of the government includes (a) the federal government, (b) 83 regions, (c) self-governments of the first-tier municipalities (520 larger cities and 1,793 rural districts), and (d) self-governments of the second-tier municipalities (1,732 townships and 19,919 rural communities).[1] In the 1990s, the system of intergovernmental relations was highly centralized. The central government controlled subnational spending standards and norms, set prices for housing and utilities services, and regulated wages of government employees. The shared taxes assigned to each region were arbitrarily determined by the central government. Intergovernmental fiscal transfers were negotiated between the federal Ministry of Finance and regional governments.

Russia faced an unstable and uncertain macroeconomic situation in the early 1990s, and the Russian government undertook a series of steps to stabilize the economy. The steps included (a) the creation of the federal treasury payment system, (b) phasing out of monetary financing to cover federal spending, (c) reducing wage and other spending arrears in the government sector, (d) liberalization of exchange rate regulation, (e) setting substantial foreign currency reserves, and (f) curbing inflation. However, the annual deficits of the federal government in the second half of the 1990s reached 7–10 percent of gross domestic product (GDP). Consequently, the government made extensive use of internal and external borrowing to cover budget deficits, which contributed to the accumulation of debt. In addition, nonfinancial instruments—barters and offsets—were heavily used.

Russian regions and municipalities also faced difficulties. The budgeted deficit was rather high in each region, and in many regions it reached 50 percent of revenues, including transfers, while revenue collection was low and unstable. Regions and municipalities actively resorted to short-term borrowing to finance their expenditures. In the mid-1990s, bank loans and bond issues became popular. At the same time, regulation of the subnational debt markets was erratic and under political influence. There were no restrictions on the amount of borrowing or the purpose of borrowed funds.

In practice, regions and municipalities borrowed mainly for current expenditures, on disadvantageous terms. They did not develop payment or debt refinancing plans. As a result, subnational entities had accumulated a significant amount of short-term debt between 1993 and 1996. In addition, in the 1990s, the Russian regions relied heavily on such unconventional short-term debt instruments as accumulation of budgetary overdue payables. In 1998, budget payables of SNGs amounted to 15.3 percent of subnational spending, or 4.7 percent of GDP. The budgetary payables, however, were nearly fully offset by overdue taxes to SNGs, thus creating the mechanism of noncash spending.[2]

Development of Regional and Municipal Bond Markets in the 1990s

During 1992–93, the bond issuance process was experimental in nature. The first bond was issued by the regional government of Khabarovsk

Krai in March 1992. The Ministry of Finance registered only five bond issues by regions and municipalities in 1992 and eight in 1993. Bonds were placed and circulated on isolated regional markets with inadequate bond market infrastructure. A clear legal framework did not exist, investors demonstrated weak interest, and market infrastructure was lacking.

From 1994 until the macroeconomic crisis in the late 1990s, regions and municipalities became more active in using bond instruments as an alternative to bank financing. The Ministry of Finance registered 28 issues of regional and municipal bonds in 1994 and 73 in 1995. In 1995 and 1996, some regions used bonds to finance 50 percent of their budget deficit. Regional and municipal bills became more popular (as a convenient instrument for which registration was not required); they were used by the authorities to untie the knot of nonpayments and finance budget expenditures. However, after enactment of the law "On the Promissory Note and the Bill of Exchange" in 1996, the government banned issuance of guarantee bills. As a result, they were replaced by regional and municipal bonds, whose issues had increased dramatically. The peak was registered in 1997, with 313 issues of regional and municipal bonds worth 29.5 billion rubles (almost US$5 billion).[3] Hyperinflation and the lack of a regulatory framework were the main challenges to the development of the subnational bond market at that time.[4]

In 1996, Russian SNGs for the first time entered the external market for borrowing. The regional governments of Moscow and St. Petersburg issued Eurobonds.[5] Borrowing in a foreign currency was motivated by significantly more attractive borrowing terms (lower rates, longer terms of loans, large amounts of borrowing); SNGs assumed that these terms would continue given the then fixed exchange rate system (the fixed exchange rate was abandoned in the late 1990s macroeconomic crisis).

During 1992–96, the Russian subnational bond market demonstrated the following features[6]:

- Issuers (Russian regions and municipalities) did not provide prospectuses, including the purpose of borrowing, of acceptable quality. Therefore, market participants had no reliable information on the financial and economic status of a jurisdiction. The bulk of the funds received from the bond issue was used to cover temporary cash gaps or simply to increase revenues.

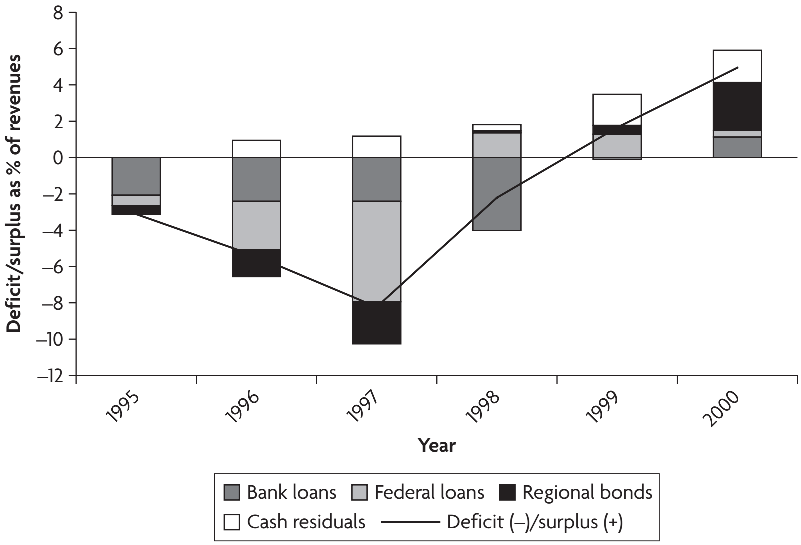
- When issuers selected agents for placing and maintaining bond proceeds, most of them gave strong preference to local financial institutions, which were small and unreliable. Thus, strong investors, facing high risks dealing with regions and municipalities, refused to enter the regional market.
- No generally accepted and guaranteed payment mechanisms existed for issued bonds. Often, debt service costs were not shown as a separate line item in regional and local budgets.
- A significant portion of bonds was used as a barter instrument for tax payments to the regional budget, which only increased the flow of real financial resources out of a region.

By 1997, the macroeconomic situation in Russia had improved: GDP began to show positive growth, and inflation and interest rates declined. Foreign capital flows increased into the sovereign debt market in response to the reduction of political risk after the 1996 presidential elections and the progressive external financial liberalization. In general, the attitude of domestic and foreign investors to Russian debt securities improved—for the first time since credit ratings were assigned to them.[7]

The activity of regional and municipal authorities in the debt securities market reached its peak in 1997, with the city of Moscow the largest and most active borrower. The total number of registered issuances of regional and municipal bonds increased more than eightfold from 1996 to 1997 (from 39 to 313). On January 1, 1998, the Ministry of Finance of the Russian Federation registered 446 issues, totaling an equivalent of US$8.3 million. About 70 percent of the total number of bond issuances during 1992–97 was registered in 1997.[8] One of the features of the regional and municipal bond market in 1997 was again that a significant portion of issuances had no particular purpose. Most of the bonds (60 percent) were short or medium term. Conditions in the securities market worsened by the end of 1997; interest rates began to rise and became unstable, while the maturity of bonds slightly increased. As a result, the pressure on regional and municipal budgets increased (figure 12.1), making debt policy planning more difficult.

Despite this, regions and municipalities continued to issue securities until May 1998. From January to May 1998, the Ministry of Finance registered 59 bond issues. However, the average monthly value of bond

Figure 12.1 Composition of Consolidated Subnational Borrowing in the Russian Federation, 1995–2000



Source: Author's estimates based on Russian Federation Treasury data.

issues fell (in U.S. dollar equivalent) from US$350,000 in 1997 to US$260,000 in 1998.[9]

The macroeconomic crisis in Russia in 1998 was triggered by both external and internal factors. The global economic slowdown that began in 1997 was responsible for the decline in world demand for oil, which had a negative impact on the Russian federal budget. Internal factors—weak monetary and fiscal policy, a fixed exchange rate, excessive government borrowing—also contributed to the crisis in August 1998. The federal government defaulted on virtually all domestic obligations and was forced to cancel the fixed exchange rate. The crisis led to a sharp devaluation of the ruble, a fall in real GDP by 5.3 percent, a jump in annual inflation to 84 percent, and the collapse of the banking system.[10]

From June to August 1998, 28 regional and municipal governments continued issuing their bonds, though the capacity of the Russian financial market was falling dramatically as a result of an abrupt outflow of foreign capital from Russia and a withdrawal of resources from the securities market by nonresident investors, followed by conversion of these resources into hard currency. During June–August 1998, the first defaults of regions and municipalities on their bonds were reported. However, the cause of the defaults was not only the worsened financial situation but also the reluctance of issuers to pay their obligations.[11]

The majority of borrowing in the precrisis era was short term and was used to finance the current budget deficit; only a small part of borrowing was to finance capital investments. Regional governments were more active in the bond market than municipalities. Before 1998, only a few subnational entities had obtained credit ratings from international rating agencies.[12] The regional governments of Moscow and St. Petersburg managed to get ratings from several international agencies.[13] In that period, issuers operating in the domestic debt market got ratings to improve their image and demonstrate their openness to the investor community. However, credit ratings had almost no effect on the amount and cost of borrowing. At the same time, it was essential for the regions wishing to access foreign debt markets to obtain credit ratings from international agencies. Prior to 1998, there were only three regional governments that borrowed in the foreign debt market—the cities of Moscow and St. Petersburg and Nizhny Novgorod Oblast.

Despite the rapid development of the regional and municipal bond market in the 1990s, its share was only a small part in the overall Russian securities market. In 1997, bonds issued by regions and municipalities accounted for only 6.6 percent of the total bond market in Russia. The growth of Russian Government Treasury Bills and Federal Loan Bonds was rapid, and new types of government securities were emerging, targeting small and individual investors. But the institution of underwriting had yet to be formed for both the federal government and SNGs.

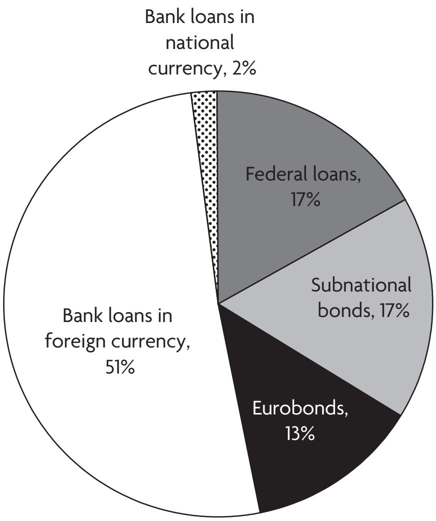
Lessons of the Crisis and Beginning of the Recovery, 1998–2000

The events of 1998 demonstrated the risks of an unregulated debt market. External borrowing was attractive at a fixed exchange rate, but the devaluation significantly increased the debt load of SNGs that borrowed in foreign currency. Even those regions that relied solely on domestic borrowing could not avoid default, since they had not received expected transfers and shared taxes from the federal government, whose situation was also grave. Between 1998 and 2001, 57 of 89 Russian regions declared default on their debts. In fact, only the federal cities—Moscow and St. Petersburg—continued to make payments on their debt obligations.[14] Figure 12.2 summarizes defaults by type of debt instrument.

A considerable share of these defaults was related to nonpayment on so-called agrobonds (as part of subnational bonds in figure 12.2). In the mid-1990s, many Russian regions received financial assistance from the central government for their agricultural sector. However, later the central government decided to convert this assistance into bonds. Many Russian regions considered this to be unfair and refused to repay after the 1998 crisis. At that time, the credit culture in Russia was relatively weak. For example, a newly elected governor or mayor could question debts raised by previous administrations.

The subnational defaults offer the following lessons: (a) borrowing in a foreign currency in the absence of reliable hedging instruments in an unstable macroeconomic environment is extremely risky, (b) unfettered market access by subnational borrowers can outpace the development of sound revenue systems and adequate security, and (c) it is essential to create a regulatory system for regional and municipal borrowing and debt market development (Alam, Titov, and Peterson 2004).

Figure 12.2 Subnational Defaults by Type of Debt Operation



Source: Standard & Poor's Global Credit Portal 2004.

The economy began to recover in 1999. Real GDP grew by 6.4 percent in 1999 after falling by more than 50 percent during 1991–98. While inflation peaked at 84 percent in the postcrisis year of 1999, it fell to below 20 percent in 2001. Foreign currency reserves grew from US$12 billion in 1998 to US$37 billion by the end of 2001.[15] Several factors contributed to the strengthening of the Russian economy and the competitive position of the country in the world market, including devaluation of the ruble, subsidized domestic energy prices, and rising world prices of oil and gas. These strengthened the export sector, which remained stable.

Fiscal performance also improved with increased tax revenues and restricted expenditure growth. In 2000, the first federal budget surplus of 1.2 percent of GDP was recorded. In 2001, the surplus rose to 2.4 percent of GDP. The ratio of public debt to GDP decreased dramatically—to 43 percent in 2001 from 145 percent in 1998 due to the strengthening of the ruble, inflation effects, partial debt payment, and a write-off of US$10.6 billion in debt under a London Club debt restructuring agreement.[16]

Eventually, starting in 2000, Russian regions and municipalities began to restore their solvency. Assets of regional and local governments grew rapidly. According to the Central Bank of Russia, on November 1, 2001, bank deposits of regions and municipalities amounted in US$1.8 billion equivalent, while their liabilities to the banking system were US$730 million equivalent. Arrears of the regions also decreased significantly.[17] During 1998–2000, increased financial resources were mainly used to refinance existing debt rather than to accumulate new debt. At the same time, by 2001 the surplus of regional budgets had reduced the subnational securities market by more than US$170 million equivalent. Changes in debt structure in favor of bank loans had also contributed to this reduction (figure 12.1). Nevertheless, despite the decline in the bond market as a whole, new subnational borrowers entered the market, while interest rates gradually returned to precrisis levels.

Public Finance Reform, Debt Regulations, and Subnational Bond Market Development, 2000–08

Improved macroeconomic fundamentals in the postcrisis period contributed to positive changes in intergovernmental relations and incentives for new principles of financial management for the regions and municipalities. New legislative and administrative initiatives aimed at the creation of a new formula-based system of relations among the tiers of government to replace the outdated, nontransparent, and informal arrangements. During the early 2000s, the legislative framework was reformed, with significant amendments to the Tax Code and the adoption of the Budget Code. Uniform standards for the allocation of tax sources were established; expenditure responsibilities were clearly assigned among all levels of government, accompanied by the reduction of unfunded mandates; and fiscal discipline has gradually been strengthened. The federal government has established a system of incentives for the development of financial management in the regions and municipalities.

On the whole, the macroeconomic situation between the early 2000s and the 2008 crisis can be characterized as successful. A favorable external economic environment contributed to the growth of the Russian economy by an average of 7 percent per year. Inflation and unemployment gradually declined, while gold and foreign currency reserves demonstrated growth. Under these conditions, the federal budget had significantly improved and showed a surplus instead of a deficit. Thus, it was possible to dramatically decrease borrowing at the federal level and reduce the amount of debt to 8 percent of GDP.

Gradually, the financial capabilities of the Russian regions began to improve. In the majority of them, revenues grew faster than expenditures, which enabled the governments to improve current budget performance and, ultimately, to direct more resources to capital projects to maintain and restore worn-out infrastructure. During the 2000s, the credit culture of Russian SNGs strengthened significantly. Debt books were cleaned, and all questionable debts inherited from the 1990s were eliminated. Many regions continued to be dependent on federal government transfers, but the level and quality of support from the federal budget had changed significantly due to reforms in fiscal relations.

Public Finance Reform in the 2000s

For the federal government, the improved economic situation had provided an incentive to implement harmonized reforms in public finances aimed at a common goal: improving the quality of public finance management at all levels of government—federal, regional, and municipal. Several important laws had been enacted, the most important of which was the Budget Code of the Russian Federation (January 1, 2000), which established the basic principles for the system of federal and subnational finances. The main provisions of the Budget Code in the area of debt relations will be discussed later.

The reform of intergovernmental fiscal relations was one of the most important for the Russian regions and municipalities. It addressed the following targets: (a) clear assignment of expenditure responsibilities across the tiers of government, (b) elimination of unfunded mandates to a lower level of government without provision of necessary financial resources, (c) allocation of taxes and tax shares among the levels of government on a long-term basis, and (d) formula-based equalization transfers to regional governments that took into account per capita fiscal capacity of a region and differences in costs of public services across regions.

Municipal governments were recognized as independent participants in fiscal relations, which became one of the fundamental features of the local self-government reform, as reflected in Federal Law #131 of October 6, 2003, "On General Principles Underlying the Organization of Local Self-Government in the Russian Federation" ("Law on Local Self-Government").

The law established a uniform two-tier system of local self-government. The first tier included townships and rural villages, and the second tier included municipal districts consisting of several townships or villages and cities. The latter referred to major cities, such as capitals of regions and several large, developed cities with dense populations within a region.

The provision of the law stating that henceforth all levels of local government were full-fledged participants in economic and financial relations was revolutionary. It meant that all municipalities (including even rural settlements with small populations) were to set up municipal governments, employ municipal office staff, formulate and execute budgets, and conduct an independent debt policy. The law assigned a set of expenditure responsibilities to each level of local self-government (local government issues) and the Budget Code specified their revenue sources.[18]

Before the reform, even large municipalities, including the capitals of regions, depended financially on transfers from regional governments. Municipal financial authorities were territorial subdivisions of the regional finance department. Most small municipalities carried out mandated financial activities given to them by higher levels of government. The 2003 “Law On Local Self-Government” actually prohibited such practice, and higher levels of government can no longer mandate activities to small municipalities.

The new system was to fully come into force on January 1, 2006. However, given the complexity of changes and the need for training of municipal officials, municipalities were given a three-year transitional period. Though some “brave” municipalities moved to a new system in 2006, most of them took advantage of the transitional period and completely switched to the new principles in January 2009, when the reform was finally implemented.

Since the second half of the 2000s, the federal government has been paying more attention to the quality of public finance management in the regions and municipalities. A Fund for Regional and Municipal Finance Reform (the Fund), to be administered by the Ministry of Finance, was established as part of the federal budget. The Fund was allocated among regions and municipalities on a competitive basis. Two separate competitions were held annually—one among the Russian regions, the other among the municipalities. Regions and municipalities participating in the contest had to prepare and submit to the Ministry of Finance a plan of the public finance reform in their jurisdictions. The areas to be reformed were delineated by the Ministry of Finance and included (a) improvement of the quality of public services, (b) introduction of a program-oriented budget, (c) raising revenue sources, (d) reforming the extended state (municipal) sector, and (d) debt management and estimation of debt capacity.

Regions (municipalities) were to identify the specific mechanisms of reform options and assess the implementation risks of planned activities. Annually, no more than eight winners were determined among both regions and municipalities whose programs were the most convincing. Also, they received funds only as a result of successful completion of the first and second stages of their plan. The received resources could be spent on funding the plan implementation, which usually covered a wide spectrum of activities, including the purchase of computer hardware and software, organization of refresher courses for public (municipal) employees, fulfillment of social obligations, and debt repayment.

Assessing Reform Results

The reforms were certainly an important step toward a better quality of public finance management in the regions and municipalities. The reform proved to be efficient in the following areas[19]:

- The revenue sources and expenditure responsibilities have been clearly assigned across levels of government and fixed in the legislation. A unified two-tier system of local self-government has been introduced across all Russia and secured by law.
- Unfunded mandates have been mostly eliminated. When federal legislation imposes additional expenditure responsibilities on lower-tier governments, the federal government allocates adequate funds to fulfill those responsibilities. This allocation takes place in a timely manner.
- A transfer formula has been introduced to equalize the fiscal capacity of regions and municipalities. This was especially important in view of the huge economic disparity among regions and the resulting uneven revenue capacity. The equalization formula, which has not changed much since then, is based on a proportional increase of per capita revenue capacity of regions below the national average. The formula also takes into account the differences in costs of public goods delivery.

Russian regions and municipalities have been encouraged to improve the quality of public finance management. The federal government has allocated grants to regions and municipalities introducing best principles in public finance management, including debt management procedures. These grants have been allocated on a competitive basis. However, the reform was followed by a number of backward steps in the following areas:

- The allocation of responsibilities among the levels of government has been modified every other year. These modifications prevent the regions and municipalities from pursuing a predictable and long-term fiscal policy. Moreover, these modifications are being introduced by the federal government at the end of the fiscal year, when regional and municipal budgets for the next period have already been formulated. Regional and municipal governments have to amend their budgets in early January.

- The revenue sources of SNGs depend on transfers. Eighty-five percent of the regions receive transfers from the federal government in the form of equalization grants, and every region receives earmarked grants. The federal government has at its disposal 200 types of earmarked grants that are provided to regional governments. Each region might receive all 200 types or fewer. Since grants are a more or less permanent source of income, the regions have less incentive to develop their own revenue base. At the same time, the value of each grant is unpredictable before the fiscal year begins. However, the federal government has tended to reduce financial support to regions. Municipalities can obtain transfers only from regional governments. Regional transfer mechanisms usually replicate the federal transfer policy regarding regions.

  As for municipalities, their revenue sources are indeed very limited. There are only two local (municipal) taxes: the personal property tax and the land tax. Their tax compliance is very poor because of problems with taxpayer registration. In addition, the administration of the land tax requires a cadastral valuation of land, which is within the power of the federal government, and the establishment of a fair market land price in the relevant documents. The portion of the federal shared taxes assigned to municipal governments by federal law (the personal income tax being the largest) improves the situation in regional economic centers. About 20 percent of regions grant additional shares of the regional taxes in favor of municipalities to improve municipal tax capacity.
- Implementation of the regional and municipal finance reform programs is often a mere formality and does not contribute to the actual quality of public finance management. For some regions and municipalities, the sole purpose of writing and implementing programs has become a way to obtain additional funds from the federal government. They hired consulting firms in order to develop and implement a detailed program. If some regional administrations were really motivated to improve the system of public finances,

others demonstrated a formal approach to the reform and did not bother with the details of the reform plan proposed by the consultants. Some regions abolished regulations whose adoption was part of the implementation of program activities after the money from the federal government had been obtained.

Despite these shortcomings, the reforms meant the emergence in Russia of an institutional environment to be further developed. With the adoption of the Budget Code, the sphere of public debt management regulations has also undergone significant changes.

Major Provisions on Debt Management in the Budget Code

The Budget Code contains provisions for regulating the subnational debt by specifying (a) the limits on the size of fiscal deficit, debt, and debt service; (b) regulations on external borrowing and guarantees; and (c) sources of deficit financing and structure and types of debt instruments.

As prescribed in the Budget Code, the budget deficit of a region should not exceed 15 percent of its annual revenues, excluding all intergovernmental transfers. Local budget deficits should not exceed 10 percent of annual revenues, excluding all intergovernmental transfers and (or) revenues from shared federal and regional taxes. The 2007 amendment to the Budget Code tightened those limits for highly subsidized regions and municipalities. The highly subsidized regions are those in whose budgets the share of intergovernmental transfers (except particular earmarked transfers) exceeded 60 percent of revenues (except particular earmarked transfers) of the regional consolidated budget. For such regions, the deficit should not exceed 10 percent of their revenues, excluding all intergovernmental transfers. For highly subsidized municipalities (where intergovernmental transfers exceed 70 percent of their revenues, except particular earmarked transfers), the deficit limit was established at 5 percent of annual revenues, excluding all intergovernmental transfers.

The Budget Code stipulates that the outstanding debt of a region or municipality should not exceed its annual revenues, excluding intergovernmental transfers. The 2007 amendments provide that the outstanding debt of the highly subsidized regions and municipalities should not exceed 50 percent of their annual revenues, excluding intergovernmental transfers. The Budget Code also stipulates that the debt service of a region or municipality must not exceed 15 percent of expenditures of the relevant year. Table 12.1 summarizes fiscal and debt rules for SNGs as stipulated in the Budget Code and its amendments.

Before 2000, foreign borrowing by a region or a municipality was not expressly prohibited by law, but in practice, it could only be undertaken on authority of a special presidential decree. The right to place loans abroad before 2000 was granted by the Russian president to the cities of Moscow and St. Petersburg, Nizhny Novgorod, Moscow, Sverdlovsk, Leningrad, Orel and Samara Oblasts, Krasnoyarsk Krai, and the Republic of Komi. These regions had issued external debt in various currencies to finance their budget deficits.

The Budget Code enacted in 2000 set severe restrictions on external borrowing. Since 2000, the regions could only borrow in foreign currency to refinance existing foreign debt. Currently, only Moscow has maintained its presence in the Eurobond market.[20] All other regional and municipal governments issue obligations only in rubles.[21] The 2007 amendments to the Budget Code granted the regions an opportunity to borrow in foreign currency starting January 1, 2011. The prerequisite for this is financial independence of a region from federal support; that is, the share of federal transfers (excluding funding federal mandates) should not exceed 5 percent of own revenues. Also, the

Table 12.1 Fiscal and Debt Rules for Subnational Governments

Rule	Regions	Highly subsidized regions	Municipalities	Highly subsidized municipalities
Deficit/revenue (excluding transfers) ceiling	10%	10%	10%	5%
Debt service/expenditure ceiling	15%	15%	15%	15%
Total debt/revenue (excluding transfers) ceiling	100%	50%	100%	50%
Term of borrowing ceiling	30 years	30 years	10 years	10 years
A ban on external (foreign currency) borrowing	Allowed to refinance foreign debt[a]		Allowed to refinance foreign debt	

Source: The Budget Code of the Russian Federation, Articles 92.1, 99, 100, 104, 107, and 111.

a. Only those Russian Federation subjects in whose budgets the share of intergovernmental transfers was less than 5 percent during the past three years are allowed to take new loans from January 1, 2011.

Russian government would develop a foreign borrowing procedure for the regions. However, at the time of writing, the procedure had not yet been developed.

The Budget Code, and especially the 2007 amendments, regulate the system of granting federal, regional, and municipal guarantees. Two types of guarantees have been established: recourse and nonrecourse guarantees. The recourse guarantee is a guarantee issued by a region or municipality to take on an obligation to pay the debt of a third party, with the right to claim the debt from the debtor. The called guarantee, according to the Budget Code, is recorded as an account receivable and not as an expenditure item. The nonrecourse guarantee is a guarantee issued by a region or municipality to take on an obligation to pay the debt of a third party, without the right to claim the debt from the debtor. The called nonrecourse guarantee is subject to recording as an expenditure item. In practice, both types of guarantees are widely used by regions and municipalities.

The Budget Code also established the sources for budget deficit financing and limited the size of the budget deficit, debt, and its service. The sources of financing the budget deficit of a region or municipality include the difference between (a) the funds received from the placement of securities and funds allocated for repayment, (b) received and repaid loans of credit institutions, and (c) received and repaid loans from government and from international financial institutions. It also includes changes in the balance of funds on accounts and other sources of financing the budget deficit. More specifically, other sources include proceeds from the sale of shares and other equity, foreign exchange rate differences, and funds allocated for execution of government guarantees.

The Budget Code also established the structure of regional and municipal debt and its types and maturity. The debt structure of regions and municipalities is limited to government securities, intergovernmental loans, loans from financial institutions, and guarantees. The maximum maturity of debt obligations is set at 30 years for the regions and 10 years for municipalities. At the same time, the federal government is not liable for debt of regions and municipalities that are not guaranteed by the federal government.

The 2007 amendments to the Budget Code included a requirement for regions and municipalities to record and register their debt obligations in their respective financial statements. The recorded information includes the types of debt, the date of contracting the debt, and the date of repayment in full or in part, forms of security, and arrears. The information from regional and municipal debt books is subject to mandatory transfer to the Ministry of Finance, which monitors the regional and municipal observance of the constraints imposed by the Budget Code. If a region or municipality violates such constraints, it will be unable to incur new debt until the situation once again meets the requirements of the Budget Code.

The limit on the size of debt raises a question about the evaluation of a subnational's creditworthiness. The size of debt itself is not the main factor affecting the creditworthiness of the government. Much more important are the structure of debt and the cost of debt service, namely, the period of repayment, the currency of borrowing, the interest rate, and the amortization of debt payment. The limit on budget deficit also raises an issue for financing large-scale infrastructure projects with major capital requirements. A severe limitation on the total amount of borrowing during one financial year may have a negative impact on the effectiveness of the investment policies pursued by regional and municipal governments, since regional and municipal governments may have to scale down the size of investment and lose the economies of scale in infrastructure networks.

Since guarantees are subject only to debt limits but not to current deficit limits, guarantees (nonrecourse) are being used by regional and municipal governments to finance their own expenditures through issuing guarantees in excess of deficit limits set by the Budget Code to the companies controlled by the relevant regional or municipal government that borrow on behalf of the government to finance government infrastructure projects. The funds to repay the company's debt come from grants provided to these companies from regional or municipal budgets. This is a way to avoid restrictions on current deficits as long as the total debt stays within the legal limitations.

The Budget Code does not specify restrictions on the use of borrowed funds. Even though best practices recommend using borrowed funds for funding only capital investments, Russian SNGs still often borrow to finance current expenses such as payroll and maintenance costs.[22] Unfortunately, the Budget Code does not prevent borrowing to finance current deficits. Therefore, the most frequent explanation in financial statements under the "purpose of borrowing" entry is "to finance budget deficit," without further specification of costs and projects to be covered by the identified resources.[23]

The Subnational Debt Market during 2000–08: Growing Interest in Credit Ratings

Favorable terms of international trade and successful domestic economic development in Russia, especially between 2004 and 2008, have largely neutralized negative aspects of the reform of intergovernmental fiscal relations for some of the Russian regions and municipalities. Their financial positions have strengthened considerably together with revenue growth.

Between 2003 and 2008, the aggregate revenues of SNGs more than tripled in absolute terms (while consumer prices nearly doubled). At the same time, there was a tendency in regional budgets to increase the share of current and social expenditures at the expense of capital spending.[24] This was largely due to the social security reform started in 2005, during which the federal government encouraged regions and municipalities to increase public sector wages by 50 percent in real terms during 2006–08. However, the two-year period (2005–06) of nearly 15 percent real growth per year of budget revenues was over in 2007. To balance their budgets, SNGs had to curtail the growth of current spending. This was a difficult task, given the inertia of the budgetary process and decisions already taken to increase the wages of public sector employees.

The growing burden of current expenditures on regional budgets has been exacerbated by the reduction of intergovernmental transfers to regions (table 12.2). There is a large disparity in economic development among Russian regions; in fact, a major feature of Russian fiscal federalism is the large disparity in the revenue capacity of the regions. In 2007, for example, the wealthiest region was 38 times richer than the poorest region. Federal equalization transfers reduced the gap to eight times the fiscal capacity.[25]

From 2003 to 2005, the share of total federal grants to the regional governments declined from 19 percent of the aggregate income of regions of Russia to 15 percent and stayed stable until 2008. In 2008,

Table 12.2 Annual Growth of Subnational Revenue, Including Fiscal Transfers, 2004–08
percent

	2004	2005	2006	2007	2008
Real growth, subnational (regional + municipal) revenues, including transfers	11.9	14.0	16.2	–3.9	33.9
Real growth GDP	7.2	6.4	8.2	8.5	5.2
Real growth, aggregated federal equalization transfers to regional governments	–8.6	4.5	9.8	2.0	11.0
Real growth, aggregated total federal transfers to regional governments	–4.2	2.4	27.5	–8.5	58.9

Source: Author's estimations based on data provided by the Russian Statistical Agency, http://www.gks.ru, and the Russian Federation Treasury, http://www.roskazna.ru.
Note: GDP = gross domestic product.

total grants grew to 18 percent of consolidated regional revenues and in 2009, reached 25 percent. As summarized by table 12.3, the federal government gradually shifted the focus in the area of intergovernmental fiscal relations from the equalization schemes to the stimulation of economic development of regions through special purpose transfers. The share of earmarked transfers for execution of federal mandates also rose.

However, the debt load of the Russian regions remained low at the end of 2007 (figure 12.3). According to the Ministry of Finance, total debt of the Russian regions (excluding municipal debt) at the end of 2007 was US$18 billion equivalent, or about 11 percent of aggregate regional revenues, including fiscal transfers to regional governments in 2007.[26] The regional debt was unevenly distributed across regions; five regions—the city of Moscow, Moscow Oblast, Samara Oblast, the Republic of Tatarstan, and the Republic of Sakha (Yakutia)—accounted for about half of the regional debt.

Another feature of the Russian regions' debt was its short-term character. Short-term bank loans were a major debt instrument for most Russian regions (excluding the city of Moscow and Moscow Oblast, which were the two largest borrowers on the securities market at the time). What is more, most regions (excluding the city of Moscow) placed bonds for a term not exceeding three years. The majority of SNGs had little experience in debt management and had short credit histories.

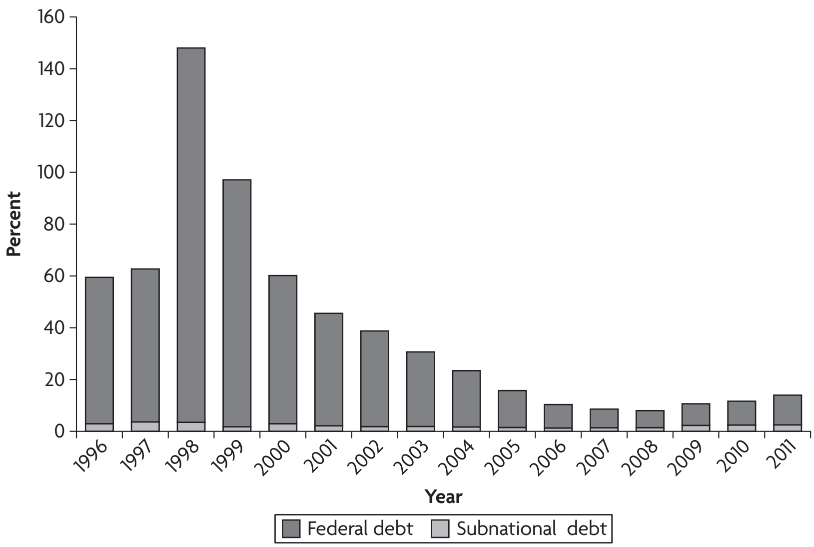
During 2000–08, regions and municipalities showed increasing interest in obtaining credit ratings from the rating agencies. The number of

Table 12.3 Intergovernmental Fiscal Transfers from the Russian Federation to Regions as a Percentage of Each Type of Transfer in Total Transfers, 2003–10
percent

Transfers	2003	2004	2005	2006	2007	2008	2009	2010
General grants	58	54	61	61	40	35	39	37
Of which equalization grants	45	43	39	47	31	29	25	28
Earmarked transfers for cofinancing regional programs	15	26	27	17	38	38	36	30
Earmarked transfers for execution of federal mandates	27	19	10	20	22	16	19	27
Other transfers	0	0	2	1	0	11	6	6
Total	100	100	100	100	100	100	100	100

Source: Author's estimations based on regional fiscal reports on the Russian Federation Treasury website, http://www.roskazna.ru.

Figure 12.3 Federal and Subnational Debt as a Share of GDP



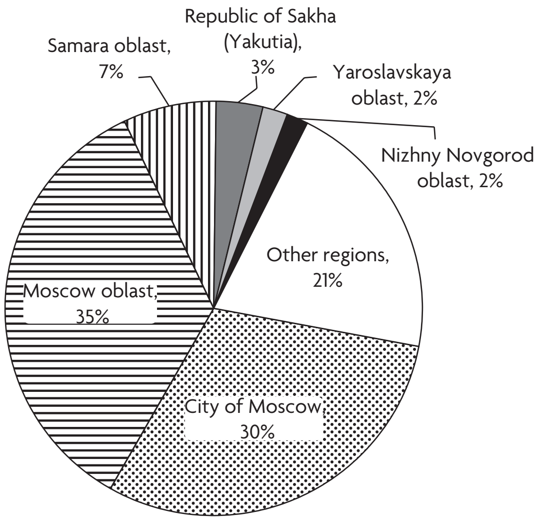
Source: Author's estimates based on Russian Federation Treasury data.
Note: GDP = gross domestic product.

ratings assigned to Russian regions by Fitch Ratings increased from only 4 in 2003 to 25 in 2008. However, the majority of ratings of Russian regions and municipalities belong to the so-called "speculative-grade" (from "BB" to "D" categories, according to the international ratings scale by Fitch); that is, they indicated a fairly high level of credit risk. Only a few regions, including the federal cities of Moscow and St. Petersburg, the Republic of Tatarstan, and the Khanty-Mansi and Yamal-Nenets Autonomous Okrugs (according to Fitch Ratings and Standard & Poor's), had ratings of "investment grade" ("BBB-" and above).[27]

Access to capital markets is limited to the most creditworthy SNGs. As shown in figure 12.4, Moscow Oblast accounted for over one-third of bond issuance, followed by the city of Moscow at 30 percent.

Lack of sustainable legal provisions and poor quality of debt management are the major constraints on increasing credit ratings of Russian regions and municipalities.[28] As a result, the average long-term ratings of Russian regions in foreign currency are significantly lower than similar ratings in European countries. The difference between Russia and Poland, the nearest country in rank, is four steps on the international rating scale. Moreover, in Russia, there is the greatest gap between the country's sovereign rating (long-term rating "BBB" in foreign currency)[29] and the median rating of Russian regions (long-term rating "BB-" in foreign currency). In this case, the gap is four steps, whereas in other European countries it does not exceed one or two steps.[30]

Figure 12.4 Regions' Share of Total Regional Bond Debt Outstanding at the End of 2008



Source: Author's estimations based on regional fiscal reports on the RF Ministry of Finance website, http://www1.minfin.ru/ru/public_debt.

Despite the fact that the crisis in Russia began to develop in the fourth quarter of 2008, when industrial production in the regions began to decline, most of the regions demonstrated quite satisfactory fiscal indicators on a yearly basis. Due to a good economic situation in the first six months in 2008, the economic growth in most regions showed a positive trend on a yearly basis. Budget indicators also remained satisfactory. Only in some regions with large industries, which were more vulnerable to the crisis, did economic decline become apparent in 2008.[31] This happened in Nizhny Novgorod Oblast, which was significantly affected by the financial woes facing the automobile industry (the industry has since recovered).[32]

The Global Economic Crisis and Its Effects: Trends and Prospects

Impact in 2009

The global financial crisis that began to unfold in the fourth quarter of 2008 severely struck Russian public finances in 2009. The budget deficit in most regions had increased, owing to a sharp decline in revenues and an inability to cut expenditures. Federal support had helped mitigate the financing gap in many regions but was not enough to fully compensate for falling revenues. As a result, the regions faced significantly larger budget deficits. The fiscal deficit grew from US$1.8 billion equivalent (or 0.8 percent of total aggregated revenue and 1.1 percent of revenue net of transfers) in 2008 to US$8.7 billion equivalent (or 5.7 percent of total aggregated revenue and 8.2 percent of revenue net of transfers) in 2009, of which about US$4.6 billion equivalent was accounted by the city of Moscow.[33] Part of the overall deficit was financed from fiscal reserves accumulated during the previous years. However, the larger part of the cumulative deficit in 2009 was covered by a more than 50 percent increase in borrowing by subnational entities. The new debt had shorter maturities that increased refinancing risks. Soaring interest rates also contributed to increasing debt service costs. Interest rates on bank loans reached 20 to 22 percent in some regions.[34]

The impact of the crisis varied among regions and municipalities. The strong regions, which relied on their own tax capacity (mainly, the personal income tax and the corporate income tax), were among the most severely affected by the crisis. These were the regions with well-developed industries. The regions that depended on exports (metallurgical and oil-producing regions) were also vulnerable. However, the regions with a greater dependence on federal transfers appeared to be less affected. On the whole, federal support to the regions during the crisis, mainly in the form of additional general purpose transfers, was the most important factor mitigating the consequences of the crisis for SNGs. In 2009, transfers increased by US$13.2 billion equivalent, or by 35 percent compared with 2008.[35] This was a crucial difference from the 1998 crisis, when the Federation provided no support to the regions and left them on their own.

In 2009, bank loans and federal government loans became the main debt instruments of SNGs. Issuance of domestic bonds almost stopped in the first half of the year. The only exception was the city of Moscow, which issued bonds as early as January 14, 2009, to borrow US$460 million equivalent at a 10 percent interest rate, a lower rate compared with costs available for other regions in 2009. Throughout 2009, Moscow was an active player in the regional bond market, which allowed the city to maintain a long-term debt profile and a smooth structure of debt repayment.

In the second half of 2009, those regions that were traditionally financially stronger began to return to the bond market. But despite this, the number of issuers decreased from 23 regions in 2008 to 10 regions in 2009. The number of securities issues dropped even more substantially—from 35 in 2008 to 16 in 2009.[36] Most other regions attracted short-term loans with a one-year maturity and interest rates that were as high as 20–22 percent per year in the first quarter of 2009. Subsequently, when the financial markets began to stabilize, a number of regions negotiated the reduction of interest rates for the remaining period to mitigate the significant growth in debt service costs. In 2009, the aggregate amount of bank loans attracted by the regions increased by US$1.7 billion equivalent compared to the previous year.[37]

In 2009, federal loans to regions became very important. Together with additional subsidies, federal loans were another form of indirect federal support to the regions. The advantages of federal loans compared with bank loans were a lower interest rate and a longer repayment horizon. In 2009, the federal government issued loans amounting to US$4 billion equivalent to regional governments, an eightfold increase over 2008.[38]

Starting in 2009, the federal loans were granted for three years. Previously, as mandated by the Budget Code, they were to be repaid within one year. The interest rate on federal loans was one-quarter of the refinancing rate of the Central Bank of Russia[39]—a subsidized rate for the regions to finance budget deficits when access to loans was limited and interest rates in capital markets were extremely high. As mentioned, the market rates peaked at 20–22 percent in the first quarter of 2009, but they declined to 11–13 percent by the end of that year.[40]

Federal loans can be divided into two groups according to their purpose. The first group of loans is the general purpose loans that are provided to cover current budget deficits. They, as a rule, have an amortized repayment structure; 60 percent of the principal is paid off in the second year and the remaining 40 percent in the third year. Such a structure smoothes out the peaks of debt repayment and makes the debt profile more favorable.

The second group is special purpose loans for construction, reconstruction, and repair of public roads. In this case, the principal is repayable at the end of the term. In 2009, the aggregate direct debt of the Russian regions increased to a US23.8 billion equivalent, that is, by almost 60 percent over the previous year. However, compared to the total revenues of Russian regions in 2009, it constituted a mere 15 percent, which, by international standards, is quite manageable. The major problem for the Russian regions was not the absolute size of a debt load but its payment structure. Reduced debt maturity terms created a substantial risk for refinancing and high debt service costs—factors that put pressure on their budgets.

Also worth mentioning are the contingent liabilities of subnational entities that include guarantees and financial debts of affiliated regional and municipal enterprises in times of crisis. Despite the fact that on the eve of the crisis the popularity of guarantees had somewhat declined, SNGs still use them widely to support the local economy. During the crisis, regions used different tactics regarding guarantees. Some opted not to incur additional risk and in difficult financial conditions refused to issue guarantees to enterprises so as not to impose additional risks on the government. At the same time, many regions supported major local taxpayers that faced great difficulties obtaining loans to develop their businesses. In that case, it was important to carefully select companies according to the most stringent criteria to mitigate possible negative consequences for the budget. The tightened rules envisioned by the Budget Code had also positively contributed to mitigating potential serious fiscal risks from guarantees.

Owing to the financial crisis of 2008 and the sharp deterioration in the construction sector, government mortgage agencies in several regions (Republic of Khakassia, Republic of Tatarstan, and Tomsk Oblast) were not able to pay their liabilities, which rquired provision of additional resources of the respective regional governments.

Novosibirsk Oblast provides an example of guarantee use in the difficult year of 2009. It granted about US$80 million equivalent of nonrecourse guarantees to enterprises of the construction sector, a most vulnerable industry during the crisis. As a result, the construction sector, a major component of the service economy of Novosibirsk Oblast, showed an increase in housing construction in 2009 compared to 2008, which was extraordinary for the Russian regions in times of crisis. Moreover, despite the nonrecourse nature of guarantees, construction companies managed to pay their debt and not add pressure on the regional budget. Thus, in this case, the guarantees helped to substantially support an important sector of the economy and prevent a significant deterioration of the oblast budget execution process, which had been predicted by many.[41]

A distinctive feature of the crisis in 2008 that differed from the 1998 crisis was the lack of defaults of regions on their debt obligations. This was due to the additional support from the federal government and the liquidity accumulated in previous years by those regions that were able to foresee a possible deterioration in the economic and financial situation and prepare for it. Accordingly, credit ratings of most regions remained at the precrisis level. Those regions that were not able to restrain the growth of current spending in 2009 (and significantly increased their debts) were negatively evaluated by the rating agencies. Their ratings were downgraded or, in many cases, the forecast on ratings was changed to “negative.”

2010: Public Finance Improved, Debt Structure Remained Vulnerable

In 2010, after the 18-month crisis, a gradual recovery of the Russian economy took place within the context of the global economic recovery. In addition to a return to favorable international economic conditions for Russia's major exports, there was a restoration of economic activity in general. Economic growth recovered from negative 7.8 percent in 2009 to positive 4.3 percent in 2010, and export growth increased from negative 35 percent in 2009 to positive 32 percent in 2010. This led to a significant increase in tax revenues, especially from the corporate income tax, an important revenue source for most Russian regions. In 2009, its reduction for regional governments amounted to an average of 40 percent compared to 2008. The level of industrial production in 2010 exceeded the precrisis level in half the Russian regions.[42]

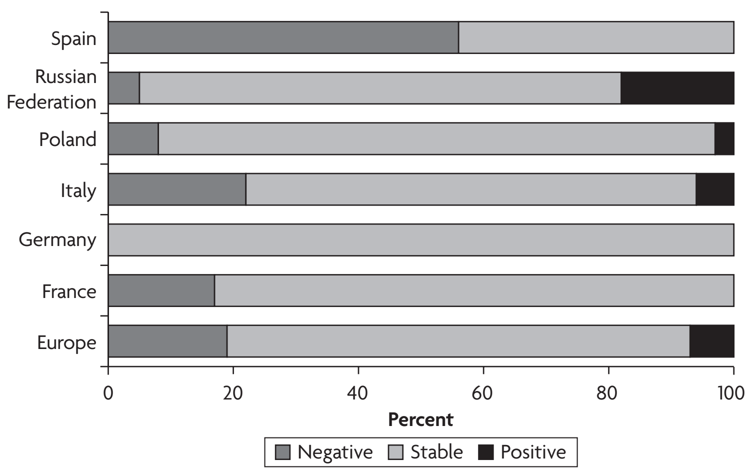
The economic recovery contributed to public finance improvement at the subnational level. In 2010, the aggregate revenues of SNGs (excluding Moscow) increased by approximately 10 percent compared to 2009 (while the 2010 inflation rate was about 9 percent). At the same time, the revenue structure of SNGs changed in 2010; the regional governments became less dependent on federal transfers. Thus, the share of various transfers accounted for 32.5 percent of total SNGs revenues in 2010 compared with 37 percent in 2009.[43] Despite the gradual recovery of tax revenue, especially from the corporate income tax, financial independence of the majority of Russian regional and local governments remains low.

In 2010, the increase in aggregate spending of the regions reached a moderate 9 percent, which is close to the inflation rate. However, the composition of expenditure changed: social spending increased, while capital expenditures decreased. The share of capital expenditures in the total regional budget expenditures decreased from 18 percent in 2008 to 13 percent during 2009–10. However, given the high demand for infrastructure development, lower capital spending in most regions should be considered a temporary phenomenon. A moderate increase in expenditure containment and an increased revenue base resulted in a lower consolidated deficit of regional budgets in 2010—1.6 percent of total aggregated revenue (compared to 5.7 percent for 2009) and 2.2 percent of revenue net of transfers (compared to 8.2 percent for 2009).[44]

In 2010, the debt markets recovered, and borrowing costs decreased. Though the debt load of the regions continued to increase, its growth rate declined. The aggregate regional debt remained moderate, at 20 percent of total revenue in 2010. At the same time, regional distribution of debt remained uneven. Ten regions accounted for about 57 percent of the total debt in nominal terms. The relative debt burden was also unevenly distributed; the median region's debt constituted 16.5 percent of total income, while the maximum level of debt amounted to 60 percent of revenues (Astrakhan Oblast). Due to federal support, Russian regions compared favorably with SNGs in other European countries (figure 12.5).

Notwithstanding the low debt as share of regional revenue, the structure of debt in most regions has considerable room for improvement. Federal loans became the main source of deficit financing of regional budgets in 2010, accounting for 45 percent of the total direct debt (excluding Moscow). However, since 2010, the terms for repayment of federal loans was extended up to five years, which extends the maturity profile of debt for the regions. The share of bank loans as direct debt amounted to 31 percent of all SNGs debt (excluding Moscow). Interest rates on bank loans declined significantly in 2010 to 7–8 percent per

Figure 12.5 Outlook on Credit Ratings: Russian Federation Regions and Subnationals in European Countries, End-December 2010



Source: Fitch Rating 2011.

year and were close to the refinancing rate of the Central Bank of Russia. This has significantly reduced debt servicing costs. In addition, banks started to offer loans for longer terms, that is, for two to three years. However, not all regions are ready for longer-term loans because the interest rate on them is usually slightly higher than on one-year loans.

Activity in the domestic bond market remained moderate. Only 13 regions issued bonds in 2010 compared to 10 in 2009. New bond issues have also had a longer period—from three to five years—compared with one to three years in 2009.

These were nonmarket instruments for financing the deficit of subnational budgets, which predominated in 2010. Also, the debt repayment profile continued to be short, owing to the large share of short-term bank loans in the debt structure. The overall structure of regional debt differs fundamentally from the debt structure of the city of Moscow, where bonds with the maturity stretched to 2022 constitute up to 90 percent of the debt portfolio.

Continuing Improvement in Subnational Fiscal Positions and More Active Subnational Debt Activities in 2011

The fiscal outcomes for the regional governments improved in 2011; the deficit of the consolidated budget of the Russian regions was 0.45 percent of revenues (excluding transfers) in 2011, down from 1.53 percent in 2010.[45] The deficit shrinking would have been stronger if not for the growth of spending commitments of all levels of government before the presidential election in 2012. On the spending composition, social outlays of the regions have outstripped their capital spending; in 2011, capital expenditures were reduced by 20 percent compared to 2008, while spending on social programs demonstrated a 71 percent increase.[46] Though in 2011, regional incomes practically recovered due to the growth of tax revenues (in the first place, the corporate income tax), their expenditures also increased and almost reached their revenue level.[47]

In 2011, the share of federal loans in the debt structure of the Russian SNGs continued to grow and reached more than 40 percent; these loans were provided at 4 percent per year, or at about half the minimum market rate.[48]

During 2011, the debt of the Russian regions grew 13.8 percent in real terms, but the total debt stock remained manageable at the end of

2011.[49] However, the structure of the debt profile remains risky. The short-term structure of the debt implies refinancing risks and the potentially high cost of repayment and debt service in the coming years.[50]

While the average debt level for the regions was 18.3 percent of revenues (including intergovernmental transfers), in six regions, the debt level is 50–70 percent. Thirteen Russian regions had to spend over 15 percent of their income on debt service. The city of Moscow accounted for 20 percent of all regional debts. In 2011, the city executed its budget with a surplus, and borrowing, therefore, was not needed.[51] A similar situation was typical for other "wealthy" Russian SNGs (for example, oil-producing Tyumen Oblast and Yamal-Nenets Autonomous Okrug), many of which were able to generate large financial reserves.

In 2011, the total volume of domestic borrowing of the regions and municipalities was reduced by 15 percent.[52] The trend of relative growth of borrowing from commercial banks continued, with a reduction by one-third of the share of issues of securities. Securities accounted for 9.1 percent of the total amount of internal borrowing of consolidated regional budgets compared to 21.3 percent of federal loans and 70 percent of borrowing from commercial banks and international credit institutions, which reflected a shrinking bond market.[53]

At the same time, the SNGs became more active in bond markets. The number of issuers increased; 21 regions and 5 municipalities registered bond prospectuses (compared to 17 regions and 6 municipalities that issued bonds in 2010). The three-largest issuers were responsible for 53.1 percent of total outstanding regional and municipal bonds in 2011. On the whole, the city of Moscow, which accounts for nearly one-half of outstanding bonds, continues to dominate the bond market.[54]

According to the "Guidelines for the State Debt Policy in 2012–14," approved by the Government of the Russian Federation,[55] there will be fundamental changes in intergovernmental fiscal relations. The volume of federal loans to regional governments will be significantly reduced, and loans will be granted only "in case of emergency." As a result, the document states, "there will be a growing need on the part of the Russian regions in market borrowing." Thus, only two debt instruments would be available to the regions—bank loans and publicly sold bonds. In addition, the regions would have to return budgetary loans taken in the crisis, the peak of payments being 2012.

Challenges for Deepening Subnational Debt Markets

Key challenges facing the continuing development of subnational debt market include the following.

There is a need to develop sustainable legal provisions. Despite the fact that the system of intergovernmental fiscal relations began to take shape in the early 2000s, it is still under development. This entails an unpredictable change in intergovernmental fiscal design, which is a risk for each region and municipality in Russia. In recent years, the federal government has often decided to change the allocation of tax revenues, expenditure responsibilities, and transfer rules. At the same time, the share of flexible tax revenues in Russia—that is, revenues the regions and municipalities might influence (such as establishing a tax base or tax rate and administering the collection)—in most cases, does not exceed 10 percent of total revenues of the regional and local budgets.

The budget classification of Russia is subject to annual changes. In addition, due to the format of the budget classification (which is obligatory for every level of government), the grouping of revenues and expenditures into recurrent and capital ones can be achieved only through sophisticated and time-consuming analytical research. It is also not possible to obtain clear information on a number of crucial indicators of government performance in the area of public finance management and to do estimations of the true level of the debt burden.

Investment and debt policies are rarely coordinated by SNGs. According to best practices, all debt resources should be used only for investment purposes. However, in Russia, only a few regions operate under this scheme (the cities of Moscow and St. Petersburg, mainly). Most SNGs do not even try to compare their investment needs and volume of borrowing. This means that debt can be used both for investment and for current spending. In many respects, the underdeveloped legislation makes the situation even more serious and does not allow for realistic medium- and long-term budgeting and a long-term investment strategy.

The subnational debt portfolio remains short-term in nature. In the debt portfolio of most SNGs, one-year bank loans dominate, which leads to higher refinancing risk. In 2011, however, this situation did not cause particular concern because of the availability of sufficient liquidity in the Russian banking system. However, when liquidity tightens, the creditworthiness of SNGs with a high proportion of short-term debt may face refinancing risks. Debt maturity and interest rate structure are among the most important parameters determining the quality of the debt portfolio of a region or municipality.

Bank financing of regions is dominated by a few state-controlled banks. Due to the underdevelopment of the banking system in Russia, bank financing of SNGs is dominated by a few state-controlled banks (primarily Sberbank and VTB). The dimensions of these banks, which are based on the past branch networks of the then Soviet-state banks, allow them to compete successfully with smaller-transaction banks, in terms of pricing. However, both Sberbank and VTB comply with strict market rules vis-à-vis their customers regarding issuance and repayment of loans.

There is a lack of comprehensive accounting for liabilities of government enterprises when assessing the total debt of a SNG. Financial debts of government enterprises (their bank loans and bond issues) are contingent liabilities of a subnational entity. The Budget Code does not include such contingent liabilities in the debt definition for regions and municipalities. This means that, formally, SNGs are not responsible for the debts of such enterprises, unless the debt is explicitly guaranteed by a government. For this reason, the vast majority of SNGs do not record the debts of their subsidiaries (partially or fully owned by a government) as a component imposing risks. Government enterprises submit their often incomplete and inconsistent financial statements with significant delay. At the same time, as recent events have shown, the regions must be involved in solving problems caused by the inability of affiliated companies to repay their debts.

Conclusions

The subnational debt market in Russia began to develop in the early 1990s. Unfunded federal mandates and political decentralization contributed to the growing demand for debt instruments, including foreign currency debt. At the same time, there was a complete lack of debt regulations and SNG lacked experience in managing debt risks. Debt was issued to finance recurrent expenditures, mostly with short-term maturities. With a rapidly deteriorating macroeconomic environment in Russia in the late 1990s, refinancing risks facing SNGs rapidly rose. From 1998 to 2000, 57 of 89 regions defaulted on their debt.

Improved macroeconomic fundamentals during 2000–08 and substantial legislative reforms—significant amendments to the Tax Code, the adoption of the Budget Code, and the 2006 legislation on local self-government—contributed to positive changes in intergovernmental relations and to incentives to formulate new principles of financial management for the regions and municipalities. The current system of intergovernmental fiscal transfers allocation is formula based, extends to all levels of SNG, and takes into account key socioeconomic parameters. However, the formula changes often. Thus, the horizon for prediction of the amount of transfers is one or two years.

Russian legislation puts strict constraints on total debt amount, annual budget deficits, and debt service. Moreover, with revenue growth, the financial positions of the regions and municipalities have strengthened considerably. The debt load of the Russian regions remains low. Most Russian SNGs have no currency or derivatives risks. Debt management and budgeting processes have become more transparent. The Treasury and the Ministry of Finance of the Russian Federation publish updated information and data on budget execution and debt obligations on a regular and timely basis.

The 2008–09 global financial crisis struck Russian public finances in 2009, though the impact varied across SNGs. But there were no regional defaults, owing to support from the federal government and the liquidity accumulated in prior years by the regions. Since 2011, subnational fiscal positions have improved along with a gradual recovery of the Russian economy. The debt markets have recovered, and borrowing costs have decreased. Activity in the domestic bond market remained moderate until 2011, when the market expanded.

There are continuing challenges in subnational debt market development. Most SNGs have a short-term debt profile dominated by one-year bank loans, implying higher refinancing risk. Bank financing of regions is dominated by a few state-controlled banks. There is a lack of comprehensive accounting for the contingent liabilities of government enterprises. Debt management will need to be an integral part of fiscal policy and will need to be integrated into the budget planning and execution process. It is necessary to coordinate debt and investment policies and to extend the horizons of budget planning. Subnational entities should develop a detailed medium-term fiscal framework that forecasts financing gaps. The borrowing plan should include information on attracting the new loans, their rates, and the repayment schedule of new and existing debt obligations, including contingent liabilities.

Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

1. Subnational governments in Russia include (a) governments of the subjects of federation (the official term, but informally called "regions"), and (b) local self-government or municipal governments (the official terms, but informally called "local governments").
2. Institute for Economies in Transition 2003; Pinto et al. 2000; the RF Treasury website, http://www.roskazna.ru; and the Russian Statistical Agency website, http://www.gks.ru.
3. Author's estimation based on RF Ministry of Finance data at http://www1.minfin.ru/ru/public_debt/capital_issue.
4. Pakhomov 2009.
5. Presidential Decree #304 of April 8, 1997 (as amended on March 20, 1998), "On the issue of external bonded loans by the executive authorities of the cities of Moscow and St. Petersburg and Nizhny Novgorod Oblast."
6. Arakelyan, Kashcheev, and Shchyurikov 2001.
7. Pakhomov 2009.
8. Author's estimation based on RF Ministry of Finance data at http://www1.minfin.ru/ru/public_debt/capital_issue.
9. Author's estimation based on RF Ministry of Finance data at http://www1.minfin.ru/ru/public_debt/capital_issue.
10. The website of the Russian Statistical agency, http://www.gks.ru.
11. Arakelyan, Kashcheev, and Shchyurikov 2001.
12. Among them the Republics of Sakha (Yakutia), Komi, and Tatarstan, as well as Novgorod, Samara, and Irkutsk Oblasts and several other regions.
13. Moscow and St. Petersburg are also called Federal Cities, which have the status of subjects of the RF (in other words, regional governments). All other cities have the status of municipalities.
14. Fitch Ratings, various issues.
15. The Central Bank of Russia, http://www.cbr.ru, and the Russian Statistical Agency, http://www.gks.ru.

16. Author's estimation based on RF Ministry of Finance data, www1.minfin.ru/ru/public_debt and Central Bank of Russia http://www.cbr.ru.
17. Central Bank of Russia website, http://www.cbr.ru.
18. The Law on Local Self-Government refers only to municipalities. Hence, in this chapter, "local government" is consistent with "municipalities."
19. De Silva et al. 2009.
20. State Debt Committee of the City of Moscow, http://www.moscowdebt.ru.
21. C-Bonds Financial Information, http://www.cbonds.ru.
22. Fitch Ratings 2008a.
23. Based on author's technical assistance to regional governments.
24. Fitch Ratings 2008a.
25. By comparison, disparities in subnational revenues (richest to poorest per capita) in the Philippines are equal to 35.4 before grants, 28.1 after grants; and in Brazil, 9.3 before grants, 4.9 after grants (Braga et al. 2002).
26. Author's estimations based on regional fiscal reports on the RF Ministry of Finance website, http://www1.minfin.ru/ru/public_debt and RF Treasury site http://www.roskazna.ru.
27. Fitch Ratings, various issues, http://www.fitchratings.com. Standard & Poor's, various issues, http://www.standardandpoors.com.
28. Fitch Ratings 2008b. According to Fitch's methodology, the regions are assigned both a local currency long-term rating and a foreign currency long-term rating, even if the regions do not borrow in foreign currency (the level of these ratings is the same for Russian regions). This is done to enable a comparison of the level of ratings of the regions from different countries using Fitch's unified international scale.
29. As of June 1, 2012, the long-term rating of the RF on the Fitch Ratings international scale is "BBB" with a "Stable" outlook.
30. Fitch Ratings 2012.
31. http://www.roskazna.ru.
32. http://autopeople.ru/gaz.
33. Author's estimations based on regional fiscal reports on the RF Treasury website, http://www.roskazna.ru
34. Fitch Ratings 2011a.
35. Author's calculations based on regional fiscal reports on the RF Treasury website, http://www.roskazna.ru.
36. C-Bonds Financial Information, http://www.cbonds.ru.
37. Fitch Ratings 2011b.
38. Author's estimates based on RF Treasury data on the RF Treasury website, http://www.roskazna.ru.
39. As of June 1, 2011, the refinancing rate of the Central Bank of Russia was 8.25 percent.
40. Fitch Ratings 2011b.
41. Fitch Ratings 2010.

42. Author's estimation based on data on the websites of the RF Treasury, http://www.roskazna.ru; and the Russian Statistical Agency, www.gks.ru.
43. Author's estimations based on regional fiscal reports on the RF Treasury website, http://www.roskazna.ru. Thirty-seven percent is the average. In 15 regions, the share of transfers was between 50 and 90 percent.
44. Golovanova 2010.
45. Author's estimations based on regional fiscal reports on the RF Treasury website, http://www.roskazna.ru.
46. Author's estimations based on regional fiscal reports on the RF Treasury website, http://www.roskazna.ru.
47. Author's estimations based on regional fiscal reports on the RF Treasury website, http://www.roskazna.ru.
48. See point 2 of Article 13 of the Law on Federal Budget in 2011–12, December 13, 2010.
49. Author's estimations based on data on the RF Ministry of Finance website, http://www1.minfin.ru/ru/public_debt/subdbt/.
50. Gaidar Institute for Economic Policy 2012.
51. Author's estimations based on data on the RF Ministry of Finance website, http://www1.minfin.ru/ru/public_debt/subdbt/, and on the RF Treasury website, http://www.roskazna.ru.
52. Author's estimations based on regional fiscal reports on the RF Treasury website, http://www.roskazna.ru.
53. Author's estimations based on regional fiscal reports on the RF Treasury website, http://www.roskazna.ru.
54. Author's estimations based on data on the RF Ministry of Finance website, http://www1.minfin.ru/ru/public_debt/capital_issue/state_securities/.
55. The RF Ministry of Finance website, http://www1.minfin.ru/common/img/uploaded/library/2011/08/Dolgovaya_politika_na_sayt.pdf.

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13

South Africa: Leveraging Private Financing for Infrastructure

Kenneth Brown, Tebogo Motsoane, and Lili Liu

Introduction

With the end of the apartheid era in 1994, the Republic of South Africa entered a new stage of development with far-reaching institutional reform. After the first democratic elections in 1994, a new constitution was adopted that fundamentally changed the way the government was structured and operated. The 1996 South African Constitution created three independent and interrelated spheres of government at the national, provincial, and local levels. The national government was primarily tasked with formulating policy and delivering critical national services such as police and defense services. Provincial governments were made responsible for the delivery of health, education, and social services, while local government, as the sphere closest to citizens, was mandated with the delivery of basic services and amenities. Local government was established as an autonomous sphere of government with executive and legislative powers vested in its Municipal Council.[1]

In the post-apartheid era, South African municipalities faced a dual challenge of extending the delivery of basic services to all citizens, while simultaneously improving the quality and efficiency of existing services offered to residents. The need for infrastructure investment was immense, driven by huge backlogs of inadequate investment during the apartheid regime, reflected in aging electricity networks and water and sanitation systems. Rapid urbanization and the need to accelerate economic development also required the development of new infrastructure.

From 1994 to 2000, the municipal sector was restructured and consolidated into 283 newly formed municipalities. The amalgamation process integrated poor and wealthy urban communities, and created cities that brought together business hubs, wealthy suburbs, and townships under one administration.[2] Since the adoption of the Constitution in 1996, a series of important legislative and institutional reforms have been carried out to develop a framework for strengthening local government capacity in providing critical infrastructure and services.

The government's 1998 "White Paper on Local Government" stressed the importance of leveraging private sector finance to meet the infrastructure requirements of municipalities over the long term.[3] The White Paper proposed a three-pronged approach to deepen municipal credit markets. First, it proposed national legislation to better define the borrowing powers of municipalities and the rules governing interventions. A comprehensive framework for monitoring the financial position of municipalities was also suggested as a way of promoting financial discipline. Second, the White Paper encouraged the use of credit enhancement measures to improve the credit quality of municipalities and accelerate lending to local government. Third, concessional lending through state-sponsored entities was seen as a viable alternative to market-based lending in those cases where the quality of municipal credit prevented municipalities from accessing the market.

The 1998 White Paper was followed by extensive stakeholder consultation between 1998 and 2003, leading to the enactment of the landmark Municipal Finance Management Act (MFMA). The act sought to "secure sound and sustainable management of the financial affairs of municipalities and other institutions in the local sphere of government and to establish treasury norms and standards for the local sphere of government,"[4] with the aim of improving the delivery of services by municipalities. As part of the financial management, the MFMA provides the overarching regulatory framework for borrowing by local authorities. The act provides a comprehensive set of ex-ante rules regulating the types of borrowing and the conditions under which such borrowings can take place. Equally important, Chapter 13 of the act stipulates a procedural approach for dealing with municipalities in financial distress.

Since 2005, activity in municipal credit markets has risen rapidly. All metropolitan municipalities have in the last decade borrowed funds from the banking sector, capital markets, or both, to finance infrastructure development. Long-term borrowing increased rapidly in the run-up to the 2010 FIFA (Fédération Internationale de Football Association) World Cup, changing the landscape of municipal finance from a high level of dependency on fiscal transfers to one where borrowing plays an increasingly important role in financing capital expenditure. However, there are continuing challenges, including the lack of a fully developed secondary market, and incompatibility of short-to-medium-term debt maturities with long-term assets of infrastructure,[5] and the need to crowd-in more private financing in the market.[6]

The infrastructure financing needs of South African municipalities will remain substantial over the next 10 years, estimated at approximately R 500 billion (approximately US$59.3 billion).[7] According to the national government, existing sources of capital finance, namely, municipalities' internally generated funds and intergovernmental grants, are insufficient to meet the estimated demand. Expanding and deepening the subnational credit market is viewed by the government as critical to providing a long-term financing source. In addition, the government has broadened the financing strategy to include other sources of capital finance, such as development charges, land leases, and public private partnerships (PPPs).[8] The national government also views sound financial management practices as essential to the long-term sustainability of municipalities.[9]

This chapter reviews the South African strategy of leveraging private financing for infrastructure and the accompanying legislative and institutional reforms. The rest of the chapter is organized as follows. Section two examines institutional reforms since the 1996 Constitution, particularly the enactment of the landmark MFMA, which defines a framework for municipal finance and access to the financial market. Section three presents the borrowing framework for municipalities—ex-ante rules for municipal borrowing and an ex-post system for addressing municipal financial distress. Section four discusses the development of the municipal credit market since the enactment of the MFMA, its progress, and challenges. Section five presents the government's strategy for leveraging private finance by linking four complementary elements: debt financing, land asset-based financing, and PPPs from the financing side, and enhancing borrowers creditworthiness from the demand side. Section six provides concluding remarks.

Historical Context and Institutional Reforms

The New Constitution

The 1996 Constitution of the Republic of South Africa created a broad legislative framework for a general system of governance and provided the core institutional framework for the legislative, executive, and judicial branches of government. The Constitution elevated provincial governments and local municipalities from being merely creatures of statute to constitutional authorities.[11] Local government was established as an independent sphere of government with executive and legislative powers vested in its Municipal Council.[12] Moreover, the Constitution entrenched the autonomy of local government by prohibiting any actions by national and provincial government that might compromise or impede the ability of a municipality to discharge its constitutional obligations.

Section 139 of the Constitution opted for an administrative solution to dealing with municipalities in financial distress by allowing provincial government to intervene in the affairs of local government when a local government fails to fulfill its obligations. How these provincial interventions would be carried out, and their implications for the rights and obligations of borrowers toward their creditors, were clarified in subsequent national legislation.[13] In addition, the Constitution limited the power of the national government to guarantee subnational debt by requiring that any such guarantees be done in accordance with national legislation. Such legislation could only be enacted after consideration of the recommendations of the Financial and Fiscal Commission, a body established to safeguard the probity of public finance policies and legislation.[14]

The government's 1998 White Paper on Local Government concluded that there were too many municipalities in South Africa, and that many were not financially viable. The 1998 Municipal Structures Act provided a legislative framework for the consolidation and rationalization of municipalities in accordance with the new constitution. The act established three types of municipalities and the criteria for each type.[15]

Category A municipalities comprise the six largest municipalities with exclusive municipal executive and legislative authority in its areas. *Category B* municipalities comprise 231 local municipalities that share municipal executive and legislative authority in its area with a category C municipality within whose area it falls. *Category C* municipalities comprise local municipalities that fell under a district municipality.[16] The number of municipalities was reduced from 843 to 284. During this process, a number of urban municipalities were transformed into metropolitan municipalities, and their fiscal accounts were consolidated, enabling cross subsidization between richer and poorer areas. Following the 2011 local government elections, the number of municipalities was further reduced to 278, comprising 8 metropolitan municipalities, 44 districts, and 226 local municipalities.[17]

The financial crisis of the then Greater Johannesburg metropolitan municipality in 1997 became the first to test the provisions of Section 139 in the Constitution (box 13.1). Lessons from the crisis subsequently

Box 13.1 Section 139 Intervention in the Greater Johannesburg Metropolitan Municipality

The Greater Johannesburg Metropolitan Municipality was created in 1995 with four independent local councils under the overarching Greater Johannesburg Metropolitan Council (GJMC). Each local council could approve its own budget, and the balanced budget applied only to the aggregate budget of all councils.

Councils rolled out ambitious spending plans without adequate finance, assuming that shortfalls would be offset by surpluses of other councils. The crisis hit the GJMC in July 1997 with unpaid bills of R 300 million to Eskom, the national electricity supplier. All local councils faced severe cash flow pressure due to low revenue collection and overambitious capital budgets, and the GJMC itself had underfunded reserves of R 1.8 billion.

The Minister for Development Planning and Local Government made a legislative intervention in late 1997 (the first time a provincial government used Section 139 of the Constitution), supported by the National Treasury. An emergency loan was arranged with the Development Bank of South Africa, and a Committee of experts was instrumental in bringing expenditure in line with revenues. The crisis led to broader reform of the municipal governance structure in the country.

Sources: City of Johannesburg 2002; The Water Dialogue South Africa 2009; World Bank 2003.

influenced the drafting of the Municipal Financial Management Act and its emphasis on ensuring that the deleterious effects of municipal financial crises on service delivery are contained.

White Paper on Local Government

The ending of national government guarantees on municipal borrowing placed the obligation for debt service with the subnational governments themselves. The capital market would then need clarity on a framework for borrowing rules, including remedies in the event of municipal financial distress and emergency. Since such a framework was yet to be developed, municipal credit markets (and, in particular, the bond market) started to collapse after 1996. No new bonds were issued by any municipality until 2004 (after the enactment of the MFMA in 2003).[18] Naturally, this limited the ability of municipalities to finance infrastructure development through debt financing.

The national government's 1998 White Paper on Local Government aimed to address these concerns. The White Paper and the 2000 Policy Framework for Municipal Borrowing and Financial Emergencies make it clear that government policy regarding municipal borrowing must be based on a market system and on lenders pricing credit to reflect the risks they perceive.[19]

The government's 1998 White Paper on Local Government stressed the importance of using capital markets to leverage private investment. It notes that "Ultimately, a vibrant and innovative primary and secondary market for short and long term municipal debt should emerge. To achieve this, national government must clearly define the basic 'rules of the game.' Local government will need to establish its creditworthiness through proper budgeting and sound financial management, including establishing firm credit control measures and affordable infrastructure investment programmes. Finally, a growth in the quantum, scope and activities of underwriters and market facilitators (such as credit-rating agencies and bond insurers) will be required. … The rules governing intervention in the event that municipalities experience financial difficulties need to be clearly defined and transparently and consistently applied. It is critical that municipalities, investors, as well as national and provincial government, have a clear understanding of the character of their respective risks. Risks should not be unduly transferred to national or provincial government."

As reviewed by the South African National Treasury (2001), the White Paper stresses the importance of both private sector investors and capital markets. Private sector lenders and investors are important not only because they bring additional funding to the national table but also because they tend to have better expertise for evaluating projects and credit risk and for managing outstanding loans than do public sector lenders. Active capital markets, with a variety of buyers and sellers and a variety of financial products, can offer more efficiency than direct lending for two reasons: (a) competition for municipal debt instruments tends to keep borrowing costs down and creates structural options for every need; and (b) an active market implies liquidity for an investor who may wish to sell, and liquidity reduces risk, increases the pool of potential investors, and, thus, improves efficiency.[20]

The White Paper provided the basic foundation for the formulation of more detailed policies and laws governing local government. It included proposals on how local government would relate to the national fiscus[21] and general guidelines on financial structures for local government. More important, the White Paper acknowledged the need to leverage private sector finance to meet the infrastructure requirements of municipalities.[22]

The White Paper proposed a three-pronged approach to deepen municipal credit markets. First, it proposed national legislation to better define the borrowing powers of municipalities and the rules governing interventions. A comprehensive framework for monitoring the financial position of municipalities was also suggested as a way of promoting financial discipline. Second, the White Paper encouraged the use of credit enhancement measures that could be used to improve the credit quality of municipalities and accelerate lending to local government. Third, concessional lending through state-sponsored entities was seen as a viable alternative to market-based lending in those cases where the quality of municipal credit prevented municipalities from accessing the market.

Municipal Finance Management Act

From 1998, when the White Paper was issued, to 2003, a series of legislative reforms was carried out to pave the way for the development of a unifying framework for the management of municipal finance. This included introduction of the Public Finance Management Act of 1999 to regulate financial management within the public sector, in order to ensure that the revenue, expenditure, and assets and liabilities of national and provincial government would be managed effectively. The act made the newly established National Treasury responsible for the establishment of uniform treasury norms and standards, and required that every government department or constitutional institution should have an accounting officer. The accounting officer would be the chief executive, and this individual would ultimately be responsible for the institution's finances. The act thus introduced greater accountability for public finances.

The enactment of the MFMA 2003 marked the culmination of an extensive consultation process among stakeholders. It necessitated two constitutional amendments[23] before the bill could be enacted. Since its first tabling in Parliament in 2000, 41 committee hearings were held to discuss and deliberate on the bill, which reflected the challenges associated with safeguarding the independence of local government while allowing national and provincial governments to fulfill their policy making and oversight functions.[24] Three consecutive versions of the Municipal Finance Management Bill were ultimately tabled before the enactment of the final act in 2003.

The extensive consultation process was needed in order to synthesize the interests of the various parties—the Treasury, lenders, and local government. A case in point is the challenge of addressing financial distress in municipalities when the interests of borrowers and lenders diverge, and the national government has multiple objectives: the fiscal sustainability of municipal government, delivery of essential public services, and development of municipal capital markets. At the heart of the procedures for dealing with municipal financial distress are debt and fiscal adjustment.

However, under the original Section 139 of the Constitution (1995–2002), few remedies existed to effect debt and fiscal adjustments for a financially troubled local government. Budgets, spending, and taxes were under the purview of the Municipal Council. Intervention into local government affairs by provincial government was limited to cases where an "executive obligation" was not fulfilled. The province could only issue a directive to the council or assume responsibility for the obligation.

Various proposals were put forward to effect debt and fiscal adjustments for a financially troubled municipality. In July 2000, the Department of Finance (now the National Treasury) put forward the Policy Framework for Municipal Borrowing and Financial Emergencies. It clarified the powers and procedures of municipalities to raise debt. It acknowledged that, with the ending of national government guarantees, the system of municipal borrowing with national guarantees would need to be replaced by local responsibility for raising market-based financing. To assure that municipal borrowing from capital markets is effective and efficient, the legal and regulatory environment must be clear and predictable. Both borrowers and lenders must have good information, and the risks from poor decisions must be appropriately assigned. It also noted the need for a systematic approach to dealing with financial emergencies of local government.[25] It proposed the establishment of an administrative agency overseen by the judiciary to manage the financial recovery of local authorities.[26]

The first version of the Municipal Finance Management Bill was tabled in Parliament in July 2000. This was followed by a revised bill published in August 2001 and reintroduced in Parliament in 2002. The basic framework defining the municipal borrowing power and procedures was already articulated in the original bill. For example, Chapter 6 of the original version regulated municipal borrowing and contained a number of important changes. The bill described the specific procedures for securing short-term debt. A municipality was permitted to incur short-term debt only if a resolution of the municipal council had approved the debt agreement and the accounting officer has signed an agreement that created or acknowledged the debt. Clause 45 of the bill therefore put in place a system of checks and balances to ensure that short-term financing is not abused by either the political or administrative arms of the municipality.[27]

The debates and amendments focused on several issues, including two main issues of particular concern to municipal borrowing.

The first issue concerns the borrowing power of municipalities. Specifically, it concerns the balance between the intervention power of other spheres of government (national and provincial governments) and the autonomy of local governments, as empowered by the South African constitution, when a municipal government faces financial stress or insolvency. The original bill envisaged the Municipal Financial Emergency Authority as an independent financial recovery service outside the influence of the executive and legislative branches. The final version of the bill reduced the powers of the Municipal Financial Emergency Authority and shifted the responsibility for overseeing an intervention to the Member of the Executive Council (MEC) responsible for local government within the province. A national entity, in the form of the Municipal Financial Recovery Service, would assist in implementing the financial recovery plan, while the MEC for local government leads the intervention. The revision tried to strike a balance between local autonomy and intervention in the South African system of decentralization.

The second issue concerns the protection of private creditors in the event of municipal fiscal stress. Despite the need for capital markets to finance infrastructure, long-term private lending to municipalities was essentially flat from 1997 to 2001. Municipal debt owed to the private sector did not change greatly during the period, generally remaining between R 11 and R 12 billion. At the same time, debt owed to public sector institutions, including the Development Bank of Southern Africa (DBSA), grew significantly—from R 5.6 to R 8.1 billion. This increasing reliance on public sector debt was viewed as inconsistent with the government's policy goal of increasing private sector investment. While new policies and legislation will not, by themselves, guarantee that private sector lending increases, there would be no chance of an increase without clear policies and legislation, according to the government.[28]

The revised bill afforded additional protection to creditors. Credit agreements for the refinancing of short-term debt could be upheld if the creditor had acted in good faith when entering the agreement with the municipality. Refinancing of long-term debt was permitted by the bill under certain conditions (Section 3). The bill sought to promote an open and transparent municipal credit market by providing within the legislation assurances to lenders that they could rely on the written representation of the municipality signed by the accounting officer.[29]

Two constitutional amendments (South Africa Act No. 34 of 2001 and South Africa Act No. 3 2003) paved the way for dealing with financial distress within municipalities. The amendments make the debt issued by the current local council valid beyond the term of the council and expand the power of other spheres of government to intervene in legislative aspects, such as the budget or the imposition of taxes. The MFMA, enacted in 2003, contains a new framework for municipal finance and borrowing. Chapter 13 of the act spells out detailed criteria for interventions and financial recovery plans, specifies the role of higher-level governments and courts in the insolvency mechanism, and outlines the fiscal and debt adjustment process. Only courts can stay debt payments and discharge debt obligations.[30]

Intervention is potentially strong and can involve substantial loss of local political autonomy. Types of interventions include the issuance of directives, full loss of municipal autonomy in financial matters under mandatory interventions, and dissolution of the Municipal Council in extreme circumstances. Primary responsibility lies with the provincial government, but the central government may intervene when the province is unable or unwilling to act.[31]

The South African experience demonstrates the complexity of subnational borrowing and insolvency legislation and the importance of building political consensus among various stakeholders. Broad support may require concerted effort over a number of years. It took South Africa two years to develop the basic policy framework (1998–2000), another year for cabinet approval (2001), and an additional two years of parliamentary debate on the constitutional amendments and on the MFMA (2001–03).[32]

Regulatory Framework for Municipal Borrowing

The MFMA was enacted in 2003 to ensure the sound and sustainable management of the financial affairs of local governments and their institutions. The act is a comprehensive piece of legislation that regulates the preparation of municipal operational and capital budgets and the management of revenue, expenditure, and debt. In addition, the act enhances political and managerial accountability by clearly specifying the roles and responsibilities of the mayors and accounting officers. An essential part of the act was to provide a framework for municipal borrowing, averting financial crises, addressing financial distress, and ensuring the sustainable financial management of municipalities. The act regulates municipal borrowing by providing a comprehensive set of ex-ante rules and creating a sound framework for dealing with financial distress.

Legal Provisions Governing Borrowing

The MFMA seeks to ensure the long-term fiscal sustainability and sound governance of local government. Reforms around capital budgeting are designed to bring greater certainty and transparency to municipal budgets by ensuring that the costs and benefits of a project over its lifetime are fully disclosed. Specifically, Section 19 of the MFMA enforces prudent financial management by requiring that the total cost of the capital project be disclosed, along with the implications of such capital expenditure on future operational costs and on municipal tariffs and taxes. The act also places the onus on a municipality to ensure that the various possible types of funding available are considered and analyzed in choosing the appropriate mix of financial sources.

Chapter 6 of the MFMA sets out the procedures for securing short- and long-term debt. Municipalities can incur debt, following the approval of the municipal council and a signed debenture agreement by the accounting officer.[33] Long-term borrowing is restricted to financing capital expenditure to ensure that future generations are not held accountable for operational expenditure incurred by the current generation. (From a public policy perspective, long-term borrowing relieves current generations from bearing excessive costs by paying cash for infrastructure that will serve many generations ahead.) The act adopts a broad definition of debt, which it defines as "a monetary liability or obligation created by a financing agreement, note, debenture, bond, overdraft or by the issuance of municipal debt instruments; or a contingent liability such as that created by guaranteeing a monetary liability or obligation of another."[34] By including contingent liabilities in the definition, the act promotes a comprehensive approach to managing and monitoring both short- and long-term debt.

Refinancing of debt is strictly controlled, as follows: (a) long-term debt is refinanced only if the existing long-term debt was lawfully incurred, (b) refinancing does not extend the term of the debt beyond the useful life of the assets for which the original debt was incurred, (c) the net present value of projected future payments (including principal and interest payments) after refinancing is less than the net present value of projected future payments before refinancing, and (d) the discount rate used in projecting net present value must be in accordance with prescribed criteria.[35]

Chapter 6 makes allowances for the provision of security as collateral, but places strict conditions. A municipality may, by resolution of the council, pledge security for any debt obligations of its own or its municipal entity, but the act restricts the municipality's ability to pledge any infrastructure involved in delivering minimum levels of basic services. Such infrastructure can only be pledged subject to the constraint that in the event of default, the creditor may not sell or change the asset in any way that will affect the delivery of basic services.[36]

The act permits municipalities to issue guarantees, provided they receive the approval of the National Treasury, and only if such a guarantee is backed by cash reserves for the duration of the guarantee, or if the municipality's exposure to risk in the event of a default by the guaranteed entity is insured by a comprehensive policy. Checks and balances introduced include the provisions in Section 51 of the act, which explicitly prohibit national or provincial governments from guaranteeing municipal debt, except to the extent granted by Chapter 8 of the Public Finance Management Act of 1999.[37]

Legal Provisions Governing Resolution of Financial Distress

Chapter 13 of the MFMA governs the resolution of financial distress and emergencies of municipalities. It provides a framework for debt relief and restructuring and the types of, and criteria for, provincial and national interventions. More important, the MFMA recognizes the rights of municipal creditors and the role of the courts in enforcing credit agreements. Thus, the act aims to foster greater confidence in the regulatory framework of local government, which over time will improve the ability of local government to access capital markets or commercial loans at lower rates.

Triggers for financial distress and emergencies. Section 135 of the MFMA places the primary responsibility for avoiding, identifying, and resolving financial problems in a municipality with the municipality itself. To facilitate the timely identification of any such problems, Section 71 of the MFMA makes it mandatory for the municipality's accounting officer to produce monthly budget statements no later than 10 days after the end of every month, and requires the accounting officer to report to the Municipal Council on any anticipated or actual shortfalls, overspending, and overdrafts. The act provides for a supervisory role for the National Treasury.

Although the MFMA does not provide an explicit legal definition of financial insolvency, it does make reference to instances when it is either mandatory or discretionary for the provincial government to intervene in the event of a financial crisis. Intervention in the financial affairs of a municipality becomes mandatory "as a result of a crisis in its financial affairs" or when a municipality "is in serious or persistent material breach of its obligations to provide basic services or to meet its financial commitments, or admits that it is unable to meet its obligations or financial commitments" (Section 139). That is, an intervention by the provincial government must occur not only if the municipality fails to pay its creditors, but also if it fails to supply basic services.

There are, however, other instances when a municipality must notify the provincial government and the relevant minister. The act categorizes such intervention as discretionary and, in such cases, it would then be up to provincial government and officials to decide whether or not to intervene. These instances are outlined in Sections 135, 136, 137, and 138. They require that the municipality notify the provincial government if any of the following occur[38]: (a) the municipality fails to make payments when they are due, (b) the municipality defaults on its financial obligations due to financial difficulties, (c) current expenditure exceeds current revenue for two consecutive financial years, or the deficit exceeds 5 percent in a particular year, and (d) the municipality does not produce its financial statements on time, or its accounts are not signed off by the Auditor General.

Early warning system. The MFMA outlines a comprehensive system of monitoring and reporting, serving as an early warning system to identify financial problems in municipalities. Each layer of reporting allows financial problems to be identified, analyzed, and addressed. Periodic reporting is prescribed by Section 71, which requires the accounting officer of a municipality to report the differences between any budgeted and actual expenditure, revenue, and borrowings. All material differences must be accompanied by an explanation, and the report must be submitted to the mayor and the relevant provincial treasury by no later than 10 days after the month ends. Provincial treasuries are required to consolidate reports and submit a statement on the state of municipalities.[39] Hence, both the provincial and national treasury are able to identify current or potential financial problems and take remedial action to assist the municipality through less intrusive means.

Notwithstanding the reporting provisions in the MFMA, Section 135(5) places the responsibility on the municipality to report serious financial problems to the MEC for local government and finance in the province. Similarly, should the MEC for local government become aware of any serious financial problems, the MEC must assess the situation and determine whether an intervention in terms of Section 139 of the Constitution is warranted.[40]

Fiscal adjustment. The Municipal Financial Recovery Service is a legal mechanism created to administer the financial recovery of municipalities. Established through Section 157 of the MFMA, the Municipal Financial Recovery Service is responsible for preparing a financial recovery plan and monitoring its implementation at the request of the MEC of finance in the province concerned.[41] The Municipal Financial Recovery Service may also assist in identifying the causes of financial problems and potential solutions. Prior to its implementation, the recovery plan must be submitted to the municipality, MECs for local government and finance, organized government in the provinces, organized labor, and suppliers or creditors of the municipality. Comments received from these stakeholders must be taken into account when finalizing the financial recovery plan.[42] Under the current legislative framework, the Municipal Financial Recovery Service falls within the National Treasury, and its staff are employed within the public service.[43]

To secure the municipality's ability to deliver basic services and meet its financial commitments, the financial recovery plan contains a minimum set of activities that the municipality must perform to restore its financial health and service delivery obligations.[44] In the case of mandatory intervention, the financial recovery plan's interventions must set out spending limits and revenue targets, outline budget parameters, and identify specific revenue-raising measures. The plan creates a binding legislative and executive obligation on the municipal council. This provision was included to counter the potential risk of a newly elected municipal council implementing its own spending priorities and creating further financial strain on the municipality.

Debt relief and restructuring. Chapter 13 of the MFMA provides for the resolutions of financial problems in municipalities, and Part 3, in particular, provides for debt relief and restructuring. "If a municipality is unable to meet its financial commitments, it may apply to the High Court for an order to stay, for a period not exceeding 90 days, all legal proceedings, including the execution of legal process, by persons claiming money from the municipality or a municipal entity under the sole control of the municipality" (Section 152(1) of the MFMA). The act provides for a voluntary form of liquidation while protecting the municipality and preventing creditors from incurring further losses.

Similarly, under the provisions of Section 153 of the MFMA, the Court may suspend or terminate the municipality's financial obligations and settle claims (in accordance with Section 155), under certain conditions, including that the provincial executive has intervened in terms of Section 139, a financial recovery plan to restore the municipality to financial health has been approved for the municipality, and that the financial recovery plan is likely to fail without the protection of such an order. More important, in an attempt to protect the delivery of basic services, the court must ensure that all assets not necessary to the delivery of basic services have been liquidated in accordance with the financial recovery plan.

The court must be satisfied that (a) the municipality cannot currently meet its financial obligations to creditors, and (b) all assets not reasonably necessary to sustain effective administration or to provide the minimum level of basic municipal services have been or are to be liquidated in accordance with the approved financial recovery plan for the benefit of meeting creditors' claims (Section 154).

Section 151 of the MFMA guarantees the legal rights of a municipality's creditors and their recourse to the courts. When the court issues an order to settle claims against the municipality, the MEC for local government must appoint a trustee to prepare a distribution plan. Preference in a distribution plan is given to secured creditors, and, thereafter, the preferences as outlined in the Insolvency Act (1936) are applied. Any distribution plan must be approved by the court prior to settlement.

Fiscal monitoring. The National Treasury started systematic monitoring of local government fiscal positions in 2009. The 2011 report, "State of Local Government Finances and Financial Management," shows improvements in local government fiscal management, as demonstrated by an increase in unqualified audit reports as a share of total audit reports during that year. The report also evaluates seven areas of fiscal management, from cash management to debt growth, and identifies 66 of 283 municipalities under financial stress. Not all of the stress was related to debt problems. Some problems, as identified in the Auditor General's reports, emanated from weak financial management, poor governance, and low levels of capacity within municipalities. The 2011 report also noted that 19 municipalities and 3 district municipalities (about 6 percent of the country's population) were under constitutionally mandated Section 139 interventions. As analyzed in the next section, the MFMA has revitalized municipal credit markets. The findings from the implementation experience of Section 139 of the MFMA will help strengthen the regulatory framework.

Development of Municipal Credit Market

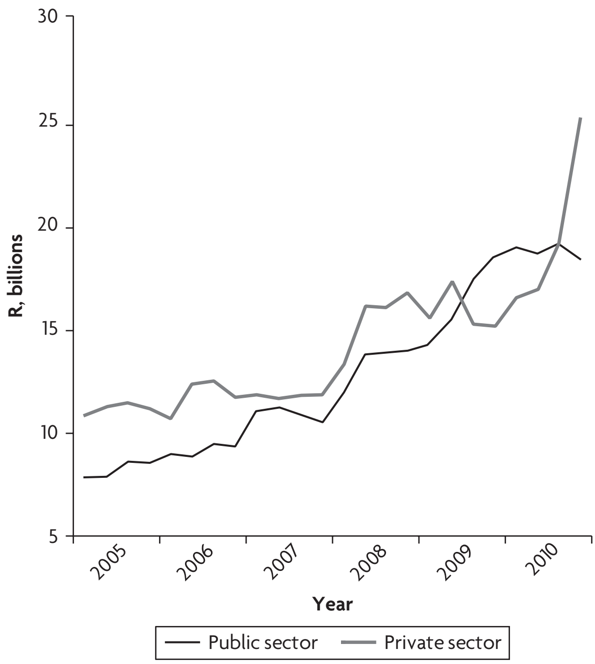
Changes in the legislative and regulatory framework will invariably impact the working of municipal credit markets. The MFMA regulates both short- and long-term borrowing by municipalities and determines the permissible uses of borrowing, and places certain obligations on the municipality in raising long-term debt. These factors have influenced the demand side of municipal credit markets and the landscape of local government borrowing. Regulatory reforms also improve the credibility of financial information, giving potential lenders more accurate information on the financial position of municipalities. This allows them to assess the credit quality of local governments and price their risks accurately. According to lenders, the promulgation of the MFMA and the concomitant reforms in financial management and reporting have enhanced the credibility of information produced by municipalities, enabling commercial lenders to profile municipal risks more accurately.

Having a legal framework that dealt with financial emergencies was also an important consideration by lenders in the extension of credit toward local government.[45]

Municipal Borrowing

Total municipal borrowing (total closing balances in outstanding municipal borrowings) grew from R 18.7 billion in 2005 to R 38.1 billion in 2010, representing an average annual growth of 15 percent (figure 13.1).[46] Private sector lending to municipalities outpaced public sector lending except in 2009, when the global financial crisis impacted the domestic lending market.

Figure 13.1 Trends in the Municipal Borrowing Market, South Africa, 2005–10



Source: South African National Treasury 2011c, with data from the National Treasury local government database.

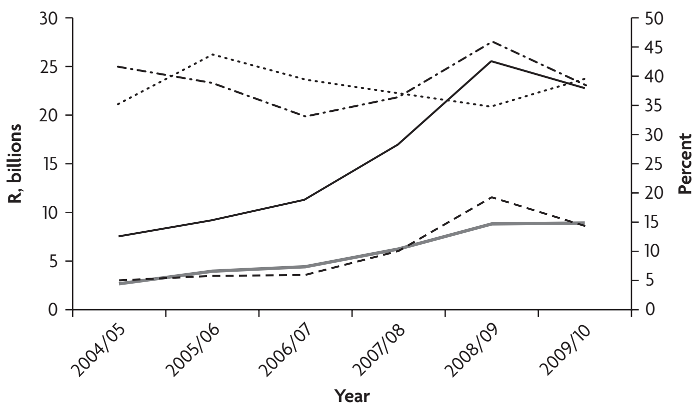
Metropolitan Borrowing

Capital expenditure in South Africa's six metropolitan municipalities, which cover 35 percent of the population, tripled during 2004/05 to 2009/10.[47] World-Cup-related expenditure accounted for a significant portion of this increase, particularly for the cities of Cape Town, eThekwini, Johannesburg, and Nelson Mandela Bay.

The six original metropolitan municipalities used external borrowing to finance a large portion of this increase in capital expenditure. External borrowing was the highest source of funding of capital expenditure from 2005/06 to 2007/08, with government transfers becoming the most significant source starting in 2008/09 (figure 13.2).

Given the increased capital expenditure and borrowing activity, the cumulative amount of long-term debt has increased markedly since 2005. However, the increase relative to revenue is less dramatic (figure 13.3); metropolitan revenues increased strongly from 2005/06 to 2008/09, and, thus, borrowing relative to revenue remained at around the same level of 35 percent of total revenues. Long-term debt as a share of revenues

Figure 13.2 Metropolitan Municipality Capital Expenditure, South Africa, 2004/05–2009/10

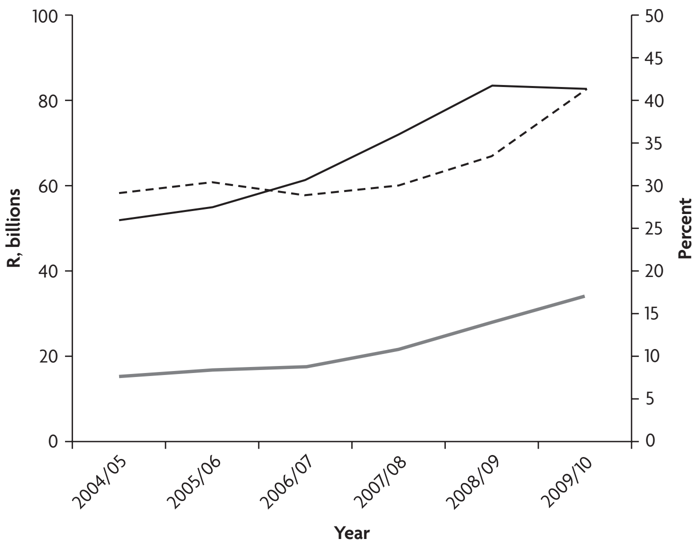


—— Capex	7,567,704	9,188,683	11,268,969	17,018,685	25,490,729	22,721,404
—— External loans	2,668,137	4,014,656	4,440,292	6,273,537	8,868,887	8,961,320
- - - Grants and subsidies	3,150,497	3,569,452	3,737,871	6,195,073	11,647,871	8,756,004
······ External Loans/Capex	35.3 %	43.7 %	39.4 %	36.9 %	34.8 %	39.4 %
–·–· Grants/Capex	41.6 %	38.8 %	33.2 %	36.4 %	45.7 %	38.5 %

Source: http://www.mfma.treasury.gov.za.

Note: The data cover six metropolitan municipalities: Cape Town, Ekurhuleni (East Rand), ethekwini (Durban), Johannesburg, Nelson Mandela (Port Elizabeth), and Tshwane (Pretoria).

Figure 13.3 Metropolitan Municipality Borrowing, South Africa, 2004/05–2009/10



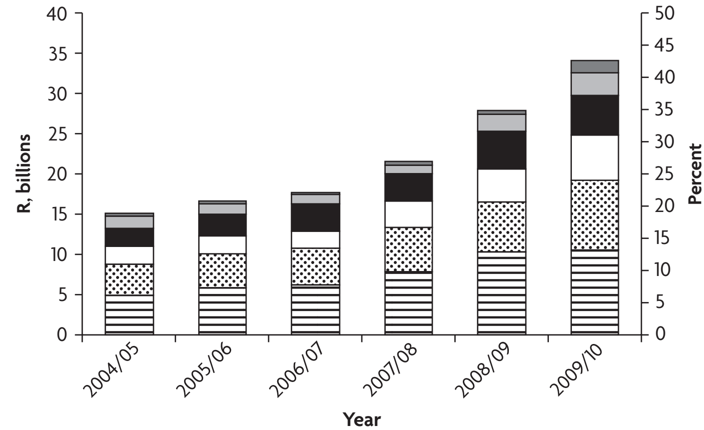
—— Revenue	51,925,949	54,960,591	61,077,481	72,059,720	83,355,499	82,804,490
—— Borrowings	15,178,497	16,703,274	17,657,582	21,639,150	27,870,734	34,120,510
- - - Borrowings/ revenue	29.2 %	30.4 %	28.9 %	30.0 %	33.4 %	41.2 %

Source: Annual financial statements of six metropolitan municipalities: Cape Town, Ekurhuleni (East Rand), ethekwini (Durban), Johannesburg, Nelson Mandela (Port Elizabeth), and Tshwane (Pretoria).

rose above 40 percent in 2009/10, owing to weaker revenue and increased borrowing.

The city of Johannesburg was the most active metropolitan borrower (figure 13.4); at the end of 2009/10, its cumulative long-term debt was R 10.6 billion, accounting for over a third of overall metropolitan municipality outstanding borrowing of R 34.1 billion for that year. This was followed by eThekwini and Tshwane, whose long-term debt was R 8.7 and R 5.6 billion, respectively, at the end of 2009/10. Nelson Mandela Bay's share of total debt by metropolitan municipality increased from 2 percent in 2008/09 to 4 percent in 2009/10 as its borrowing increased from R 442.4 to R 1.46 billion, largely due to the raising of new loans for 2010 World-Cup-related infrastructure. Previous research reveals that this dramatic increase in debt contributed partly to the city's subsequent financial woes.[48]

Figure 13.4 Outstanding Debt of Metropolitan Municipalities, South Africa, 2004/05–2009/10



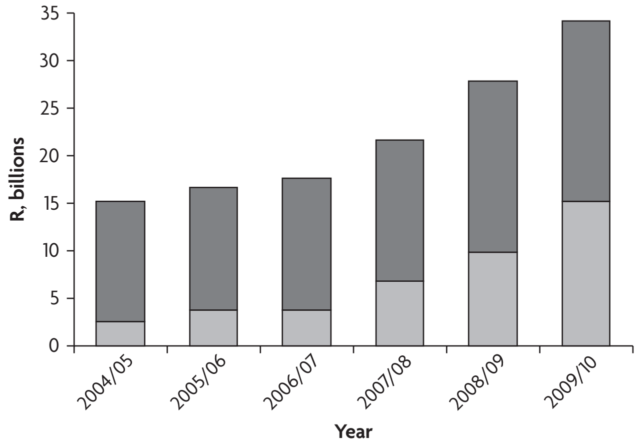
	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Nelson Mandela Bay (Port Elizabeth)	374,518	342,383	222,597	498,834	442,395	1,461,015
Ekurhuleni	1,533,666	1,348,348	1,182,431	1,127,824	2,076,914	2,881,085
Tshwane	2,256,577	2,733,854	3,356,646	3,401,190	4,701,642	4,927,395
Cape Town	2,180,030	2,164,352	2,068,949	3,290,175	4,133,283	5,566,231
eThekwini	3,866,672	4,284,596	4,656,173	5,412,084	6,161,492	8,674,686
Johannesburg	4,967,034	5,829,741	6,170,786	7,909,043	10,355,008	10,610,098

Source: Annual financial statements of six metropolitan municipalities: Cape Town, Ekurhuleni (East Rand), ethekwini (Durban), Johannesburg, Nelson Mandela (Port Elizabeth), and Tshwane (Pretoria).

Municipal credit markets in South Africa remain relatively undeveloped, with a limited amount of borrowing instruments available to municipalities through which to raise financing. Amortizing loans from domestic commercial banks are the principal borrowing instrument used by the metropolitan municipalities. Bonds are becoming an increasingly important source of borrowing, with bonds (amounting to R 15.2 billion) accounting for 55.5 percent of outstanding debt in 2009/10 (figure 13.5). Johannesburg, in 2004, was the first South African metropolitan municipality to enter the bond market, followed by Cape Town in 2008, and, most recently, by Ekurhuleni in 2010.

Debt service costs as a share of revenue is a critical measure of the debt sustainability of a government. Based on international experience,

Figure 13.5 Debt Composition of Metropolitan Municipalities, South Africa, 2004/05–2009/10



	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Bank loans	12,668,497	12,973,273	13,927,583	14,782,285	17,969,917	18,950,891
Bonds	2,510,000	3,730,000	3,730,000	6,856,865	9,900,817	15,169,619

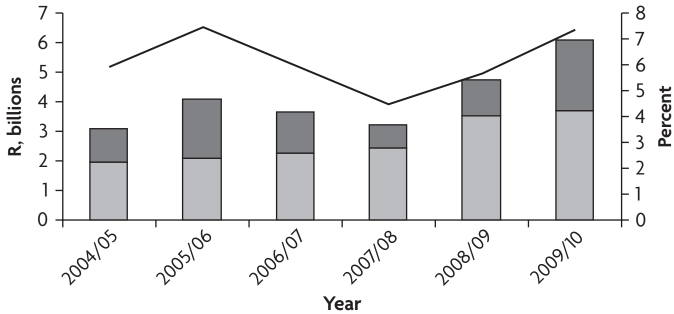
Source: Annual financial statements of six metropolitan municipalities: Cape Town, Ekurhuleni (East Rand), ethekwini (Durban), Johannesburg, Nelson Mandela (Port Elizabeth), and Tshwane (Pretoria).

prudential guidelines suggest that debt service costs are often capped at no more than 15 percent of municipal total revenues.[49] For the six original metropolitan municipalities in South Africa, aggregate annual debt service costs (including interest and principal repayments) increased from R 2.8 billion in 2004/05 to R 6.1 billion in 2009/10, and the ratio of debt service to revenue increased from 4.5 percent in 2007/08 to 7.4 percent in 2009/10 (still well below the prudential limit of 15 percent) (figure 13.6).

Borrowing by Secondary Cities

The growth of secondary cities reflects the rapid urbanization in South Africa. The 19 secondary cities comprise 1.8 million households and a population of 6.25 million, or 13 percent of the country's population.[50] Many of these secondary cities are likely to become the next generation of metropolitan municipalities. Secondary cities are critical urban nodes, and the demand for public services infrastructure within these cities has increased significantly. While, traditionally, secondary cities have largely relied on fiscal transfers to finance capital expenditure,

Figure 13.6 Debt Service Costs, South Africa, 2004/05–2009/10



Loan principal repaid	1,122,775	1,992,604	1,372,170	755,230	1,227,975	2,420,297
Total finance costs	1,943,147	2,101,242	2,262,561	2,452,026	3,514,435	3,681,506
Debt service cost/revenue	5.9 %	7.4 %	6.0 %	4.5 %	5.7 %	7.4 %

Source: Annual financial statements of six metropolitan municipalities: Cape Town, Ekurhuleni (East Rand), ethekwini (Durban), Johannesburg, Nelson Mandela (Port Elizabeth), and Tshwane (Pretoria).

borrowing from municipal credit markets has become an important source of finance to augment capital budgets.

Aggregate borrowings by the secondary cities increased over the last five years, from R 2.4 billion in 2004/05 to R 4.2 billion in 2009/10. Most secondary cities have been conservative borrowers relying largely on fiscal transfers. However, a small number of secondary cities, particularly uMhlathuze, George, Rustenburg, and Msunduzi, borrowed aggressively during this time to augment capital budgets, with an increase in borrowing from 2004/05 to 2009/10 of 1,749, 523, 395, and 70 percent, respectively, though from a low base (table 13.1).

Two of these 19 secondary cities, Msunduzi and uMhlathuze, ran into financial trouble as a result of this rapid increase in long-term debt and debt service costs relative to their revenue increase. For Msunduzi, the provincial government staged a constitutionally mandated Section 139 intervention, and uMhlathuze municipality adopted a voluntary recovery plan. Financial recovery plans were implemented in both cases.[51]

To summarize, the MFMA is viewed by lenders as the most critical factor in revitalizing the municipal credit markets.[52] Borrowing by metropolitan municipalities tripled between 2004/05 and 2008/09, which suggests a willingness by market participants to lend to metropolitan

Table 13.1 Secondary City Long-Term Borrowing, South Africa, 2004/05–2009/10
R, millions

City	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
uMhlathuze	51,097	134,954	429,379	411,670	767,236	893,888
Msunduzi	356,834	336,123	315,412	421,126	463,577	607,435
Madibeng	316,610	347,094	373,393	394,221	445,137	486,051
George	61,626	141,142	227,313	310,108	403,515	384,016
Rustenburg	70,112	89,473	88,330	156,649	359,459	346,941
Emalahleni	258,895	242,690	226,485	210,280	300,339	272,243
Drakenstein	106,305	92,491	56,799	142,312	186,167	250,987
Steve Tshwete	101,930	124,809	113,443	134,424	152,393	167,503
Matlosana	190,097	180,377	170,657	160,937	151,590	141,105
Mogale City	327,035	205,125	185,800	155,299	153,134	119,931
Govan Mbeki	114,310	111,423	108,536	105,649	102,762	99,875
Emfuleni	125,167	120,811	116,455	112,099	105,254	99,492
Newcastle	12,740	33,437	66,565	78,037	78,045	84,877
Sol Plaatje	59,806	56,635	53,464	49,950	64,964	66,435
Polokwane	92,492	92,492	92,492	92,492	92,492	50,000
Mbombela	100,706	93,604	85,260	77,653	65,758	58,151
Stellenbosch	8,356	33,580	33,597	38,204	29,768	38,183
Matjhabeng	54,140	48,987	43,834	38,681	39,095	29,591
Tlokwe	32,808	25,013	17,218	32,498	22,483	22,686
Total	2,441,895	2,511,089	2,805,261	3,073,118	3,983,998	4,220,219

Source: Secondary city annual financial statements.

municipalities and secondary cities. Commercial loans have been the mainstay of municipal lending, but bond markets are an increasing source of funding for metropolitan municipalities, which reflects an increasing confidence from debt capital markets in local government and its regulatory framework. From the perspective of municipalities, the MFMA has also brought regulatory certainty by specifying the borrowing power of municipalities and the procedural rules for incurring debt. More important, the act regulates capital budgeting, thus ensuring that borrowed funds are used for the development of infrastructure. The act also addresses the concern of investors by developing remedies in the event of municipal financial distress and emergency.

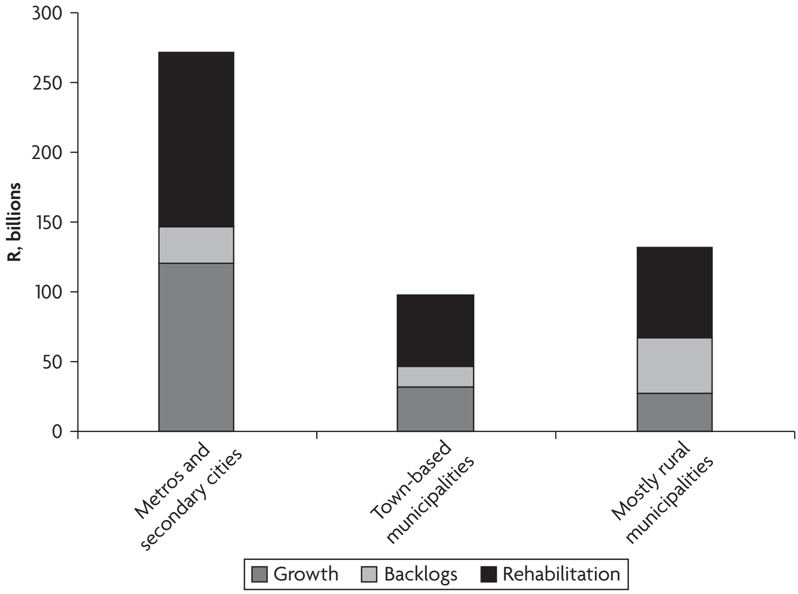
Analysis of South African municipal borrowing and debt cannot be separated from the consolidated public debt of South Africa. Debt limits for subnational governments must take into account the fiscal space available for the total public sector, that is, national and subnational. For any given resources available to repay the total public debt, the borrowing space is ultimately split between national and subnational entities (Liu and Pradelli 2012). National government debt has been managed countercyclically and is mostly denominated in domestic currency.[53] Total debt outstanding has declined from about 58 percent of gross domestic product (GDP) in 1998/99 to about 36 percent in 2010/11, albeit with an increase from 2008/09 to 2010/11, due to countercyclical fiscal policies. Yields on foreign currency debt are lower than those on domestic currency debt and are mostly long term.[54] The market estimates a low default risk, which, like those of its peers, varies with global risk aversion. South African government debt has attracted nonresident interest despite the exchange rate risk.

Broadening the Strategy for Leveraging Private Financing[55]

Over the next 10 years, the municipal infrastructure financing needs of South Africa will remain substantial—an estimated R 500 billion (US$59.3 billion) (figure 13.7), of which R 421 billion (US$49.9 billion) is required to finance new infrastructure and rehabilitation, and R 79 billion (US$9.4 billion) is required for the eradication of backlogs.[56] According to the national government, revenues to municipalities from own revenues and national fiscal transfers are insufficient to meet the scale of municipal infrastructure investments. Thus, the government has laid out a strategy of leveraging private finance through multiple sources—borrowing, development charges, land leases, and PPPs—to mobilize additional resources to fund infrastructure investments. At the same time, sound financial management practices are essential to the long-term sustainability of municipalities.

While municipalities need to explore ways of leveraging primary sources of finance to mobilize additional resources for funding infrastructure investments, the capacity of municipalities to leverage private finance differs significantly. The investment needs of the 140 municipalities that are anchored by smaller cities and large towns (so-called B2 and B3 municipalities) amount to about R 98 billion (US$11.6 billion).[57] These municipalities often find it difficult to access capital markets, either because the scale at which they wish to borrow

Figure 13.7 South African Municipal Infrastructure Investment Requirements, 2010–19



Source: World Bank 2009.

makes lending expensive, or because weaknesses in their financial management make them a poor credit risk for lending institutions.

The investment requirement of the 70 mostly rural municipalities (so-called B4 municipalities) is estimated to be R 131 billion (US$15.5 billion)[58] over the next 10 years; however, the borrowing capacity of these municipalities is very limited. Since average household incomes in these municipalities are very low, their ability to collect revenues from property rates and service charges is limited. Consequently, these municipalities will continue to rely mainly on government transfers to fund their capital budgets. Generally, borrowing to finance their infrastructure needs is not an option, unless provided on special terms by development finance institutions.

Deepening Municipal Credit Markets

As noted, private sector lending to municipalities outpaced public sector lending from 2005 to 2009. During the recession of 2009–10, total public sector lending exceeded private sector lending for the first time since 2005. Private lenders became more risk averse, with total debt from late 2008 to the end of the third quarter of 2010 remaining flat. In addition, the Infrastructure Finance Corporation Limited, a major lender to municipalities, withdrew from the market in 2009, citing declining margins due to competition from public sector lenders. In contrast, public sector lending—almost entirely from the DBSA accelerated during this period, resulting in total public sector lending exceeding private sector lending.

The municipal bond market remains small and underdeveloped, accounting for only 2 percent of total government bonds listed on the Johannesburg Stock Exchange. Bonds have been issued by three metropolitan municipalities (Cape Town, Ekurhuleni, and Johannesburg). Municipal bond repayments are typically structured with a large, lump-sum (or "bullet") payment at the end of the repayment period. This creates a spike in municipal debt repayment profiles that requires careful management to minimize the risk of default. Ideally, the debt service profiles of municipalities should be growing broadly consistent with revenue growth. Deferring higher levels of debt service to later years can indicate current fiscal pressure. If adequate reserves (a sinking fund) are not set aside over the period of the bond, the municipality could be forced to refinance the final bullet payments with additional debt. International experience shows that the development of serial maturities is crucial for market development and for managing refinancing risks and maturity profiles.

Although there has been a recent recovery in private lending to municipalities, there is a concern that both the historical and current level of private lending to municipalities is still limited, notwithstanding the legislative and policy reforms that have been introduced to stimulate private sector participation (see section three). Recent research indicates that the development of the municipal credit market is being limited by the following five factors:

- *Lack of a developed secondary bond market.* A secondary market would enhance the liquidity of bond instruments because it enables municipal bondholders to trade the instrument. The limited size of the municipal bond issuances to date is itself an obstacle to the development of a secondary market. The South African bond market is dominated by pension funds and insurers that invest funds with the intention of holding until maturity. The lack of a developed secondary municipal bond market means investors with shorter time horizons are reluctant to buy long-term instruments whose term matches the economic life of infrastructure investments.

- *Short maturities on loans.* The short maturities offered by banks means that municipalities cannot obtain loan tenures that are in line with the life span of assets. Municipalities are compelled to finance long-life assets with medium-term funds. This means that rates and tariffs have to be higher in the medium term, and funds have to be used to fund higher debt service costs rather than services over the period of the loans.
- *Creditworthiness.* Borrowing should be used to finance infrastructure that will generate income for the municipality, either directly through tariff income or indirectly through higher property rates income. Currently, many municipalities are using borrowing to fund social infrastructure, which costs money to operate but does not expand their revenue base. This negatively impacts the creditworthiness of municipalities and, together with many municipalities' overall poor financial performance, has reduced their capacity to incur further debt.
- *Lack of treasury management capacity.* Treasury management skills and capacity vary significantly across municipalities. Most municipalities do not have clear borrowing strategies that support their infrastructure investment programs. Improving treasury management capacity within municipalities will help optimize their borrowing activities, including their debt profile.
- *The role of the DBSA.* While the increased lending by the DBSA to municipalities is a welcome development, going forward it needs to explore strategies for partnering with the private sector to crowd-in lending to local government in line with its mandate. Also, the DBSA's loan book should reflect an appetite for risk that is somewhat different from that of private sector institutions and more commensurate with lending to municipalities at the lower end of the market.

Through the Regulatory Framework for Municipal Borrowing (1999) and the MFMA (2003), the government has already implemented a range of measures to facilitate municipal borrowing, as presented in sections two and three of this chapter. With the ending of the sovereign guarantee for municipal debt, except those approved following Chapter 8 of the Public Financing Management Act (1999), the MFMA provides legal recourse to investors through Chapter 13 of the MFMA.

Section 48 of the MFMA states that a municipality may provide any appropriate security for its debt obligations, and presents a range of options in this regard, including pledging specific revenue streams, ceding rights to future revenues, and so on. These provisions are supported by a provision in the annual Division of Revenue Act that allows municipalities to pledge future conditional grants as reflected in the medium-term expenditure framework. It is important that these credit enhancements are carefully designed and implemented to reduce moral hazard, and that they do not impede the delivery of basic services.

There is no legal provision that allows the national government or provincial governments to lend funds directly to municipalities. The national development finance institutions (such as the DBSA) are responsible for lending to municipalities, in accordance with their mandates, and may provide interest rate subsidies in accordance with their developmental role. The government is committed to facilitating the development of secondary markets for municipal debt to enhance the liquidity of the municipal credit market, lower the risk of lenders, and, thus, lower the cost of borrowing for municipalities.

Facilitating Municipality Access to Private Finance

The government is also exploring ways of enabling municipalities with no, or only limited, access to financial markets to access private finance.

Pool finance for secondary cities. The basic idea of pool finance is to create an instrument for secondary cities with similar credit qualities that will allow them to pool their financing needs and approach the financial markets collectively.

Secondary cities have large funding requirements (borrowing was R 4.1 billion [US$500 million][59] at the end of 2010), adequate own revenues, and good institutional capacity. However, they lack the finance expertise to issue bonds independently, and the scale of their financing needs makes it uneconomical to approach the bond market separately.

It is envisaged that this bond pooling instrument would reduce transaction costs of the underwriting process due to increased economies of scale.

Such bond pooling would be cost-effective for secondary cities since they would benefit from the longer maturities and lower debt costs generally associated with bonds. In addition, bond pools can be structured to achieve higher credit ratings in the primary market, which would further reduce the cost of the debt.

DBSA fulfilling its developmental role. Development finance institutions in some developing countries have been instrumental in lending to municipalities with good potential but whose balance sheets are comparatively weak, thus developing the lower end of the capital market. The government and the DBSA have agreed that the DBSA should increase its support for municipalities in line with its developmental mandate. This will entail increasing lending to those municipalities that currently do not have access to credit markets. It is also envisaged that the DBSA will increasingly play the role of market facilitator and, thereby, crowd-in private finance, instead of acting as a primary lender and effectively crowding out private finance. Steps that the bank is being encouraged to take in this regard include:

- Championing a model that involves private sector cofinancing of the projects it invests in
- Providing technical support to municipalities to build their capacity to participate in credit markets generally, and not simply to facilitate the DBSA's own lending activities
- Facilitating municipalities' entry and participation into private capital markets by underwriting municipal borrowing or offering limited guarantees to municipalities
- Managing the development of a bond pooling instrument for secondary cities (using the DBSA's extensive treasury expertise)
- Encouraging the development of the secondary market in municipal bonds by selling its current holdings of metropolitan municipality bonds to secondary investors that are more likely to trade them.

To support these initiatives, the government has raised the DBSA's callable capital by R 15.2 billion to R 20 billion, thereby increasing its lending capacity to R 140 billion. The government is also exploring ways to reduce the DBSA's exposure when lending to municipalities that are a credit risk.

Developing the treasury function capacity in municipalities. Generally, the treasury function capacity of municipalities is weak, even among some metropolitan municipalities. The result is that municipalities are not managing their borrowing optimally. This leads to municipalities either underutilizing their borrowing capacity or borrowing excessively and getting into financial difficulties. It is also reflected in the unevenness of many municipalities' debt profiles. The National Treasury will be exploring ways to strengthen municipalities' treasury functions, which may include providing specific training, developing appropriate guidelines, and providing technical advice to municipalities on how to optimize their borrowing strategies.

Development Charges, Land Leasing, and PPPs

Development charges. A development charge is designed to pass on the up-front costs to the responsible developers, who will then pass it on to their customers. The municipal infrastructure required to support new property developments is typically very costly. There are essentially two approaches to financing it.

In the first approach, the municipality borrows the required funds on the strength of its balance sheet and then repays the debt with income derived from all ratepayers and customers of the municipality, including those that benefit from the new development. In the second approach, the property developer is required to pay a development charge equivalent to the up-front cost of the new municipal infrastructure (and the cost of using the capacity of existing infrastructure) and passes these costs on to whomever buys into the development. Essentially, the new landowners finance the cost of the infrastructure, which may be through commercial debt, such as home loans in the case of residential property developments.

One instrument that brings together the debt instrument and benefits taxation is the use of tax incremental financing,[60] which helps link local governments' own revenue with infrastructure financing. Applying the "benefit" principle of public finance means that those who benefit more from a product or service should pay for it in proportion to the value they derive from it. Tax incremental financing is used for financing infrastructure and other community improvement projects in many countries, including the United States. Tax incremental financing uses future gains in taxes to finance current improvements, which are projected to create the conditions for future gains. The completion of an infrastructure project, such as power and water, often results in an increase in the value of the surrounding real estate, which generates additional tax revenue. Tax incremental financing dedicates tax increments within a certain defined district to finance the debt that is issued to pay for the project. It creates funding for public or private projects by borrowing against the future increase in these property tax revenues.

A development charge is designed to pass on the up-front costs of the new municipal infrastructure associated with specific developments to the responsible developers, who, in turn, will pass it on to their customers—the users of the new infrastructure. These users derive a direct benefit from the provision of infrastructure, since its value is reflected in their property valuations.

Development charges are, thus, an important component of a sustainable system of municipal infrastructure finance and, if used judiciously, can play an important role in accelerating the overall development of municipal infrastructure. This is because, without these charges, the infrastructure required for new developments would have to be financed within the confines of the municipality's capital budget. This means that the new infrastructure would need to be prioritized relative to other municipal projects, which may result in it being delayed for many years, particularly where municipalities' scope to borrow is limited due to weak balance sheets and poor credit ratings.

When the municipality decides to invest in the new infrastructure, it would mean delaying other capital projects. It would also mean that the costs related to specific developments are unfairly borne by all residents in general, since the municipality would raise the required funds from its entire rates and tariffs base.

It is generally accepted that using development charges is economically efficient in that the user pays. Their absence creates distortions in the economy, particularly through underpricing the cost of development in some municipalities and contributing to the underprovision of municipal infrastructure more generally. This, in turn, acts as a significant constraint to growth and job creation.

Development charges are not a general revenue source for municipalities. Rather, they are a one-off fee that must be used to cover the cost of municipal infrastructure associated with a new development. They do not cover the ongoing operating costs of the services that the infrastructure is used to provide or the future cost of the rehabilitation or replacement of the infrastructure. These costs ought to be funded through property taxes and user fees. Development charges are also not intended to cover the cost of infrastructure that is internal to a development, such as sewerage or water connections to private stands or infrastructure within the boundaries of a new development. These costs are always borne fully by the landowner.

Development charges are imposed to meet the costs of bulk and connector infrastructure, such as water mains that bring services to the boundary of the development, and infrastructure costs associated with the utilization of existing capacity or the need to expand the capacity of water storage and treatment facilities, substations, and sewerage treatment works.

The use of development charges has declined in recent years. Among the metropolitan municipalities, development charges were 2 percent of the value of buildings completed in 2004/05. This declined to 1.7 percent in 2009/10. Implementation is also uneven across municipalities. Both the decline and uneven implementation can be ascribed to weaknesses in the regulatory framework that make them administratively complex.

The National Treasury has done extensive work in relation to municipal development charges and is in the process of developing a framework that will set norms and standards to ensure that these charges facilitate (and do not stifle) new property developments. Certain municipalities have already begun revising their policies related to development charges, in line with National Treasury's research findings. All municipalities are encouraged to do the same.

Land-based financing strategies. Land assets are an important ingredient of subnational government finance in most developing countries. Land frequently is the most valuable asset on the asset side of subnational balance sheets. Direct sales of land by subnational governments are the clearest example of "capital" land financing. In addition, there are other instruments for converting public land rights to cash or infrastructure. Land may be used as collateral for borrowing, a practice that has a long history of financing urban investment. Today, land often is the most important public contribution to PPPs that build metro (subway) lines, airports, or other large infrastructure projects. Beyond physical land, rights to more intensive land development—a higher Floor Space Index or higher Floor Area Ratio—may also be sold by public development agencies. These "excess density rights" in effect represent the publicly controlled share of privately owned land. The development rights have economic value that can be sold by public authorities, as has happened in Mumbai, São Paulo, and the United States.[61]

Due to the recent rapid growth in land prices, municipal land sales have become an attractive way to mobilize finance for municipal infrastructure (and sometimes also to finance operating deficits). However, this use of municipal-owned land undermines the long-term financial health and wealth of the municipality. Even when a municipality invests the funds in municipal infrastructure, it is exchanging an appreciating asset (land) for a depreciating asset (infrastructure). As a principle of good stewardship, municipalities should always use the proceeds of municipal land sales to purchase other land for the municipality in order to maintain and grow the value of the municipality's land portfolio and to facilitate the realization of its spatial development strategy.

Apart from selling land, there are a range of other land-based strategies to raise finance for infrastructure investments that municipalities can explore. First, municipalities can use municipal land as security for raising loans to fund infrastructure related to the development of that land or other infrastructure. This is fairly common practice among municipalities.

Second, municipalities can use leaseholds on municipal land. The experience of other developing countries is that this strategy has the greatest potential where there is rapid urban growth, such as in the metropolitan municipalities and cities. The municipality will sell the development rights to the municipal land to a developer subject to the proposed development being in line with the municipality's spatial development framework. The parties may agree that part of the proceeds of the sale should be used to provide infrastructure to the approved development. The developer's rights to the property are spelled out in a leasehold agreement. Typically, this agreement should require the lessor to pay a rental at least commensurate with the rates that would be raised on the developed property. The leasehold agreement will have a specific term (20, 40, or 99 years), depending on the type of development. Usually, the developer is allowed to sell the leasehold to a third party under certain circumstances. Once the term expires, all rights in the property revert to the municipality. The leasehold system enables a municipality to partner with private developers to accelerate the development of inner-city land while retaining ownership of the land.

Third, municipalities can use land-use exchanges. The basic idea is that certain municipal offices or functions (such as stores, workshops, or vehicle depots) are located on land that can and should be used for alternative, higher-value purposes. Where this is the case, the municipality should explore relocating these offices or functions to suitable alternative locations (often on the city outskirts), and so release the high-value land for development.

In many instances, inner-city land is owned by either other spheres of government or state-owned enterprises. Municipalities need to engage with these property owners to explore ways in which they, too, can facilitate development through similar land-use exchanges.

Land-use exchanges may involve land swaps, lease swaps, or simply buying land with the funds generated from either selling or leasing the vacated land. The net result should be a more appropriate use of land that fosters development. The best known example of this kind of development is the Victoria and Alfred Waterfront in Cape Town, where a harbor was turned into a shopping mall and tourist destination.

International experience shows that the fiscal risks from land-based financing will need to be managed prudently.[62] Land sales often involve less transparency than borrowing. Many sales are conducted off-budget, which makes it easier to divert proceeds into operating budgets. Capital revenues from sales of land assets exert a much more volatile trend and could create an incentive to appropriate auction proceeds to finance the operating budget, particularly in times of budget shortfalls during economic downturns. Furthermore, land collateral and expected future land-value appreciation for bank loans can be linked with macroeconomic risks. It is critical to develop ex-ante prudential rules, comparable to those governing borrowing, to reduce fiscal risks and the contingent liabilities associated with the land-based revenues for financing infrastructure.

Public-private partnerships. PPPs are important service delivery mechanisms that facilitate rapid infrastructure development. They allow municipalities to take advantage of private sector expertise and experience. There are different types of PPPs that involve models for risk sharing between the municipality and its partners. In many cases, the private party is in a better position to raise debt and equity to finance the project. Municipalities can take advantage of private sector expertise and experience in the construction of the infrastructure. Furthermore, the development of PPPs for economically justifiable projects eases the pressure on the municipality's budget and allows better allocation of funds toward addressing social needs of the community.

There are fiscal risks associated with PPPs.[63] Often, subnational governments provide explicit or implicit guarantees for market borrowings of public enterprises that form partnerships with private investors. Challenges arise from implicit guarantees, which influence creditors' risk assessment. Moreover, there is a lack of standardized accounting, recording, collecting, and disclosing of such debt incurred by off-budget financing vehicles in many developing countries. These tasks are challenging because of an array of complex arrangements of PPPs. Subnational-owned enterprises may have different quasi-fiscal relations with the budgets of their owners—subnational governments. Adding to the complexity is the wide variety of legal contractual relationships in PPPs. There is no standard uniformity in these contractual relationships; they vary across and within sectors.

Enhancing Creditworthiness of Municipalities[64]

Sound financial management practices are essential to the long-term sustainability of municipalities. Generally, municipalities are encouraged to access private finance on the strength of their balance sheets and their credit ratings.[65] Municipal financial management involves managing a range of interrelated components: planning and budgeting, revenue, cash and expenditure management, procurement, asset management, reporting, and oversight. Each component contributes to ensuring that expenditure is developmental, effective, and efficient and that municipalities can be held accountable.

The reforms introduced by the MFMA are the cornerstone of the broader reform package for local government outlined in the 1998 White Paper on Local Government. The MFMA, together with the Municipal Structures Act (1998), the Municipal Systems Act (2000), the Municipal Property Rates Act (2004), and the Municipal Fiscal Powers and Functions Act (2007), sets out frameworks and key requirements for municipal operations, planning, budgeting, governance, and accountability.

Since 2008, the National Treasury has paid attention to strengthening municipal budgeting and reporting practices. Key initiatives have been the introduction of the Municipal Budget and Reporting Regulations in 2009, the enforcement of in-year financial reporting processes, and firmer management of conditional grants in accordance with the annual Division of Revenue Act. These reforms have been supported by strengthening the National Treasury's local government database and by publishing an increasing range of local government financial information on the National Treasury's website. The National Treasury is currently working on a number of reform initiatives, including a standard chart of accounts for municipalities, strengthening revenue and cash management policies, and finalizing the regulations for financial misconduct to facilitate the enforcement of the provisions dealing with financial conduct in Chapter 15 of the MFMA.

Conclusions

South Africa developed a comprehensive regulatory framework for the financial management practices of local government within the fundamental changes in the country's political structure and municipal system. Designing the regulatory framework in a federal system, where the subnational spheres of government are autonomous, was a consultative process in South Africa. The legislative process coordinated institutional and policy reforms and synthesized different interests of the national government, provincial government, local government, and creditors.

A key challenge was to reach a proper balance between the autonomy of local government, as granted by the 1996 Constitution, and the national government's obligation to ensure fiscal sustainability of local governments.

The South African experience shows that the benefits of having a strong regulatory framework are numerous; in particular, the regulatory framework has provided certainty and clarity on rules and procedures, giving confidence to the capital markets to finance much-needed infrastructure to its citizens, thereby improving the quality of their lives.

The enactment of the law has helped revitalize municipal credit markets. Borrowing by metropolitan municipalities tripled and borrowing by secondary cities doubled between 2004/05 and 2008/09, suggesting a willingness by market participants to lend to metropolitan municipalities. Historically, commercial loans have been the mainstay of municipal lending, but bond markets are now an increasingly popular alternative source of funding for metropolitan municipalities. This reflects the increasing confidence that the capital markets have in the regulatory framework and local government finance.

Notwithstanding the expanded activities of municipal credit markets, the markets would need continuing expansion and deepening to support substantial infrastructure investment demands. South Africa faces infrastructure financing requirements over the next decade, estimated at approximately R 500 billion. The demand for municipal infrastructure is spread across all municipalities but is greatest in the metropolitan municipalities and secondary cities. The municipal credit markets face challenges: the secondary market for municipal securities is almost nonexistent; there is a mismatch between the long-term asset life of infrastructure and the relative short maturities; and the capacity of many municipalities to manage a debt portfolio and access markets is weak. The DBSA also faces the challenges of crowding-in private creditors.

The government envisions multiple strategies for leveraging private financing for infrastructure investments. The government is exploring ways of deepening and broadening the municipal capital markets through developing a bond pooling instrument for secondary cities and building municipal capacity in managing a debt portfolio and accessing markets. It is encouraging the DBSA to fulfill its developmental role and become a market facilitator and, thereby, crowd-in private finance, instead of acting as a primary lender and effectively crowding out private finance.

Going beyond the development of competitive municipal credit markets, the government is also exploring ways of mobilizing private financing for infrastructure through development charges, land-based financing, and PPPs. International experience has demonstrated the enormous potential of these instruments in leveraging private financing, provided that the fiscal risks from land-based financing and PPPs are prudently managed.

Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

1. Section 151 of the 1996 Constitution of the Republic of South Africa, http://www.justice.gov.za/legislation/constitution/constitution.htm.
2. Nyalunga 2006.
3. Section 3 of the 1998 White Paper on Local Government, http://www.info.gov.za/view/DownloadFileAction?id=108131.
4. Preamble to the MFMA, No. 56, of 2003, http://mfma.treasury.gov.za/Legislation/lgmfma/Pages/default.aspx.
5. From a public policy perspective, matching the debt maturity term with the asset life of infrastructure is consistent with intergenerational equity (Liu 2008).
6. South African National Treasury 2011c.
7. World Bank 2009. R 8.43 = US$1, September 3, 2012.
8. South African National Treasury 2011c.
9. South African National Treasury 2011b.
10. Sections two and three draw from Liu and Waibel (2008, 2009) and background materials and work by DNA Economics, Pretoria, South Africa, commissioned by the World Bank.
11. South African Local Government Association, http://www.salga.org.za/pages/Municipalities/About-Municipalities.
12. Section 151 of the 1996 Constitution of the Republic of South Africa.
13. Municipal Finance Management Act, 2003.
14. Section 218 of the 1996 Constitution of the Republic of South Africa.
15. As of December 31, 2000.
16. Before the 2011 local government election, there were originally six *Category A* metropolitan municipalities based in the six largest cities in South Africa,

namely, Cape Town, Ekurhuleni (the East Rand), ethekwini (Durban), Johannesburg, Nelson Mandela Bay (Port Elizabeth), and Tshwane (Pretoria). In 2011, Mangaung (Bloemfontein) and Buffalo City (East London) were also declared as *Category A* municipalities. *Category B*, or local municipalities, cover the areas that fall outside the *Category A* municipalities. In 2010, there were 231 local municipalities and 44 district municipalities.

17. South African National Treasury 2011a.
18. In 2004, the City of Johannesburg went to market following its recovery from a financial crisis.
19. South African National Treasury 2011c.
20. South African National Treasury 2001c, 192–93.
21. The national fiscus refers to the government's fiscal activity and includes revenues, expenditures, and debts.
22. Section three of the 1998 White Paper on Local Government.
23. Second Amendment Act 2001, which allowed municipalities to borrow; Second Amendment Act of 2003, which legalized provincial intervention in local government.
24. Wandrag 2009.
25. Department of Finance, South Africa 2000, 2.
26. This model was informed by insolvency practices in the private sector, where the Master of the High Court appoints an insolvency practitioner to sequester an estate.
27. Republic of South Africa 2002.
28. South African National Treasury 2001, 189–90.
29. Clause 49(2) of the Municipal Finance Management Bill (B1D-2002).
30. Liu and Waibel 2009.
31. Liu and Waibel 2009.
32. Liu and Waibel 2009.
33. Section 45 of the MFMA (2003).
34. Definitions in Chapter 1 of the MFMA (2003).
35. Section 46(5) of the MFMA (2003).
36. Section 48 of the MFMA (2003).
37. Sections 70(b) and 66(3)(c) of the Public Finance Management Act allow for guarantees to be granted in special cases by the national Finance Minister in consultation with the national minister responsible for a specific portfolio, that is, the Minister of Cooperative Governance and Traditional Affairs, who is responsible for local government. Any guarantee issued by the Minister of Finance binds the effectively national revenue fund.
38. A discretionary intervention may be initiated if any of the above-mentioned conditions are met in a municipally owned entity.
39. In the case of certain larger metropolitan municipalities and secondary cities, such reports must be submitted to the National Treasury.
40. Section 136(1) of the MFMA.

41. In case of discretionary intervention, the recovery plan may be prepared by the Municipal Financial Recovery Service or by a suitably qualified person appointed by the provincial executive.
42. Section 141(3)(c) of the MFMA (2003).
43. As noted, the Municipal Financial Recovery Service as established in the act can be thought of as an administrative support structure, in contrast to the quasi-judicial structure proposed in the previous versions of the Municipal Finance Management Act.
44. Section 142 of the MFMA.
45. Jitsing, Chisadza, and Condon 2012.
46. Data from the 2004/05 to 2009/10 audited annual financial statements were been collected and analyzed and cover the original six metropolitan municipalities.
47. Data on metropolitan municipalities up to 2010 are for six metropolitan cities: Cape Town, Ekurhuleni (East Rand), ethekwini (Durban), Johannesburg, Nelson Mandela (Port Elizabeth), and Tshwane (Pretoria). In May 2011, the number of metropolitan municipalities was increased from six to eight (see note 16).
48. Jitsing, Chisadza, and Condon 2012.
49. See Liu and Waibel 2008; Liu and Webb 2010.
50. *Source:* STATSSA Community Survey 2007.
51. As mentioned, 22 municipalities (6 percent of the country's population) are under section 139 intervention. The lessons to be learned from these cases, and from the Msunduzi and uMhlathuze financial recoveries, will help strengthen implementation of the MFMA.
52. Interviews by DNA Economics of South Africa during 2010–11 with commercial banks for the National Treasury demonstrated that lenders view the MFMA as the most important factor in revitalizing the municipal credit markets.
53. Source on the assessment of national government debt: International Monetary Fund (2011).
54. Inflation-linked long-term debt and fixed-income long-term debt accounted for 81 percent of national government debt in 2010 (International Monetary Fund 2011).
55. Unless otherwise indicated, this section draws mainly from reports by the South African National Treasury (2011b, 2011c).
56. World Bank 2009. R 8.43 = US$1, September 3, 2012.
57. R 8.43 = US$1, September 3, 2012.
58. R 8.43 = US$1, September 3, 2012.
59. R 8.43 = US$1, September 3, 2012.
60. Tax incremental financing is based on the authors' own research.
61. Peterson and Kaganova 2010.
62. This draws from Peterson and Koganova (2010).
63. The discussion of fiscal risks from PPPs draws from Canuto and Liu (2010) and Irwin (2007).

64. This section draws from South African National Treasury 2011b.
65. South African National Treasury 2011c.

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14

Caveat Creditor: State Systems of Local Government Borrowing in the United States

Lili Liu, Xiaowei Tian, and
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Introduction

Economists, political scientists, and development specialists have long been interested in what happens when sovereign governments fail to repay loans, since the only laws the creditors can access to force repayment are the laws the government itself promulgates and enforces. The problem is no less challenging when nonsovereign governments fail to repay their debts. Presumably, higher-level governments can create and enforce rules for debt issue, debt repayment, and debt adjustment for their political subdivisions. However, the common pool problems and associated moral hazards pose a special challenge to fiscal adjustment and debt restructuring.[1] The ongoing fiscal challenges in numerous developed countries, exacerbated by the global financial crisis of 2008–09, have brought problems of insolvency and sovereign and nonsovereign debt to the forefront of policy debates. Many developing countries face similar challenges with their subnational governments.

Our focus is the historical development and current structure of insolvency rules for United States local governments. In many countries, all subnational governments are nonsovereign governments. But in the United States, state governments also possess sovereignty.[2] State sovereignty with respect to state debts is explicitly recognized in the Eleventh Amendment to the national constitution.[3] All of the governments below the state level, what Americans call "local government," are not sovereign, but rather are created by and subject to the laws of each respective state. In 2007, there were 89,476 local governments comprising 3,033 counties, 19,492 municipalities (cities), 16,519 towns and townships, 14,561 school districts, and 37,381 special purpose districts.[4] While these governments are widely divergent in structure and purpose, for this chapter, they are all included under the category of "local government."

The United States has by far the largest subnational government capital market in the world. In 2007, local governments issued US$225 billion in bonds, and total local government debt outstanding was US$1.5 trillion, while state governments issued US$161 billion in bonds and had US$936 billion in bonds outstanding.[5] In contrast, in 2007, subnational bonds issued by all countries outside the United States totaled roughly US$130 billion. The amount of subnational bond issuance outside of the United States expanded rapidly in the late 2000s, particularly in Canada, China, the Federal Republic of Germany, and Japan, but the subnational bond market in the United States remains larger than the rest of the world combined.[6]

If the policy goal of developing countries is to promote credible and responsible subnational government borrowing to finance infrastructure, then the experience of the United States offers instructive lessons. Rather than one unitary government, the United States encompasses 50 different regimes of local governance structure. Not only are state governments sovereign, they each design and constitute a fiscal system for their own local governments. A few states regulate local governments closely and have well-established institutions for monitoring and regulating local government fiscal performance. Other states do relatively little in the way of active monitoring. States also vary in the ways that they allow local governments to make decisions about borrowing, taxing, and spending. Many states have ex-ante limits on the amount of local government borrowing and the level of taxation and expenditures. States also place limits on the kind of functions that local governments can perform and the purposes for which bonds may be issued. Understanding what happens when local governments become insolvent, or face the possibility of a fiscal crisis, is impossible without reference to the larger set of state-level fiscal and constitutional institutions.

The intent of this chapter is to explain how the systems evolved and how they work. These issues matter enormously for developing countries. Two aspects are particularly important. The first is that the sequence of historical development matters for understanding how the system works. Local insolvency problems reached a crisis point in the late 19th century when a significant number of local governments defaulted on bonded debts. It was not clear how the liabilities of insolvent, democratically elected governments could be enforced, since enforcement almost inevitably involved imposing burdens on taxpayers and voters that they themselves might not consent to. Rather than unilaterally forcing local governments to repay debts, a set of institutions developed that clearly outlined the powers and responsibilities of local governments with regard to issuing debt, and then left it up to private capital markets to assess the risk of lending to local governments. This led to the second key aspect of the American systems: active monitoring and disciplining of most local borrowing is accomplished through private markets. The markets do not, however, operate in isolation. A series of institutions—some public, some private, and others mixed—have evolved to make local borrowing sustainable and credible. The first half of the chapter traces the historical development of the American systems, and the second half more closely analyzes the systems that are currently in place in the American states. Three dimensions of insolvency systems shape our approach. First is the distinction between ex-ante and ex-post policies. Ex-ante elements of an insolvency system come into play even before a local government decides to borrow, such as limits on the amount a local government can borrow and procedural rules on how they borrow. Ex-post elements come into play after a fiscal crisis begins and/or a default on debt has occurred.

Second is the distinction between passive and active policies. More than half of the American states have insolvency systems that rely largely on ex-ante constraints on decisions that local governments make about borrowing. These systems are passive, in the sense that the state does not take direct action or intervene in the operation of local governments in normal circumstances. Although there are some active monitoring systems in place, only a few states actually have systems that actively interfere with local government fiscal decisions.

Third, the systems work because the passive constraints provide guidelines, which private citizens, bondholders, bond underwriters, capital markets, and the courts can use to discipline and shape the interests and behavior of local governments. The chapter will describe systems in which institutions leverage up the ability of public governments and private markets to clearly identify the risks of borrowing and lending, and the revenue sources available to repay debts.[7]

More than half of the American states have completely passive ex-ante insolvency systems. Those systems are the norm. Slightly less than half of American states have insolvency systems that involve any ex-post elements that engage after a fiscal crisis is identified or begins. Part of the ex-post systems have access to Chapter 9 proceedings under the federal bankruptcy code for municipal governments that was created in 1937.[8] Twenty-three states do not allow local governments to avail themselves of federal bankruptcy procedure and nine states only do so under limited conditions.[9] Slightly less than a third of the states have more active systems for monitoring, regulating, and, ultimately, intervening in local government insolvency crises.

Despite its visibility, the Chapter 9 procedures are rarely used. From 1980 through 2009, an average of fewer than 8 cases were filed annually nationwide. Given that there are approximately 89,000 local governments, this is a take-up rate of less than 1 in 10,000 per year. From 1937 to 2011, there were roughly 600 Chapter 9 cases.[10] This chapter considers why it is that states, rather than the national government, regulate local governments. This is even true in areas where the national government has explicit constitutional permission to regulate bankruptcy.

Many local governments in the United States have been undergoing fiscal strain or crises during the recession that began in 2008. Two local governments have defaulted on their bonds (at the end of 2011). What changes the current crisis will bring to local insolvency systems is hard to predict. All the institutions that govern local governments are endogenous at the state level. Even when rules regarding local government independence are enshrined in a state constitution, that constitution is subject to change. As shown throughout the chapter, insolvency systems in the United States continuously adapt. Constitutions and laws do not change every year, but they do change over time. Both state and local governments regularly reconsider how they should interact, and it is expected that some changes will occur in the coming years.

Section two of the chapter presents several conceptual issues with regard to sovereignty and self-government in the American political system. To appreciate the dynamic nature of insolvency systems, section three begins with the early history of state constitutional provisions regarding local government borrowing, largely the passive ex-ante elements implemented during the 19th century, and then follows with the history of changes in the 20th century that leveraged the ability of private markets to coordinate with public borrowers. Section four examines state insolvency systems currently in force, including passive and active systems. Section five looks closely at three states, North Carolina, Pennsylvania, and Ohio, which have active intervention systems. Section six provides empirical results on the difference in revenues, expenditures, and debt associated with different types of insolvency systems. Section seven concludes with a review of lessons learned about the role of market discipline in the American states.

Conceptual and Constitutional Issues

The constitutional structure of American government is complicated. States are governed by the national constitution but are explicitly sovereign governments that enjoy all powers not explicitly granted to the national government in the national constitution (the Tenth Amendment). Particularly important for government debt, the Eleventh Amendment explicitly makes states immune from legal cases brought by citizens of other states or nations that they do not consent to. The relationship between states and local governments is even more complicated in ways that bear directly on local government borrowing and insolvency.

The national constitution does not affect the relationship between state and local governments.[11] In legal and constitutional terms, states play the dominant role in structuring local governments and managing municipal insolvency. But the source and scope of local government powers have long been subject to controversy and change.[12] Actual practices fall between two conceptual extremes.[13] At one extreme is Dillon's

Rule, formulated by John Dillon of the Iowa Supreme Court,[14] which holds that municipalities are simply the administrative instrumentalities created by the states to implement state policies that only enjoy powers the state has granted to them expressly and incidental thereto. States enjoy broad powers to create, alter, or abolish their local governments, change their boundaries, and modify or eliminate their powers.[15]

The other extreme is the Cooley Doctrine, formulated by Thomas Cooley of the Michigan Supreme Court, which holds that municipalities are the creations of their constituents. Consequently, municipalities enjoy some degrees of sovereignty. Municipalities have a right of self-government, and local constituents fundamentally determine the local government activities. In an important conceptual sense, all states are Dillon's Rule states. States always retain the possibility of exerting complete power over local governments within the constitutional framework of the nation. State constitutions can always be amended, so Dillon's Rule is always a possibility.[16] On the other hand, almost all states choose to allow local governments some freedom along the lines of the Cooley Doctrine, although the extent of local autonomy and choice varies widely.

The autonomy of the Cooley Doctrine is also related to concepts of sovereignty—in this case, the sovereignty of voters. To appreciate the implications of voter sovereignty for government borrowing, we need to understand that Americans draw a distinction between their governments and their citizens. Legitimate actions taken by governments are obviously binding on citizens, but actions taken by governments that go beyond the authority granted to governments by their citizens and embodied in constitutions are problematic. A government that takes an action beyond its allotted powers cannot legally bind its citizens to support the action. If the action is borrowing money that needs to be repaid from tax revenues in the future, then voter-citizen-taxpayers may have a claim that the government was acting "beyond its powers."

Exactly what powers local governments possess is complicated by Dillon's Rule, since the source of legitimate local government power is the state government and the sovereign power of the citizens. The continuing evolution of the state's relationships with local governments is far too complicated to go into in detail here, but three aspects need our attention.

The first is how state governments deal with local governments. Initially, all relationships between state and local governments were, in the legal terminology, "special," in the sense that states could deal with individual counties, municipalities, school districts, or other local governments on a case-by-case basis. Because of the political problems that special treatment involved, many states began prohibiting the state legislature from dealing with local governments on an individual basis. In many states, state constitutions began requiring that all local governments be subject to the same "general" laws that affect all municipalities in the same way, or what are called "general incorporation laws" for local governments.[17] These constitutional provisions and laws began to appear in the 1850s. States retain sovereignty over the structure and actions of local governments but can only exercise that sovereignty in a way that applies equally to all local governments. The relationship between state and local governments varies widely across states.

This can have important implications in a fiscal crisis. For example, the Ohio Constitution of 1851 prohibits special legislation for all corporate bodies.[18] As a result, when Cleveland's fiscal crisis reached a peak in 1979, the state was required to respond with legislation that governs a wide range of municipalities: cities, villages, counties, and school districts. The Ohio legislature could not pass a law that applied only to Cleveland. In contrast, New York State is not constrained by a special legislation ban. New York was able to adopt special legislation that only applied to New York City to remedy the city's fiscal crisis in 1975.

The second aspect of sovereignty is how much latitude states allow their local governments in structuring their internal governance and deciding which functions to perform. The first general incorporation laws in the 1850s tended to be quite narrow, specifying exactly (or within a narrow range) what local governments could do. This one-size-fits-all rule had obvious costs, and beginning in the 1880s, many states allowed local governments some measure of "home rule." Home rule grants local governments limited rights to self-government and may limit how states can intervene in local affairs. Home rule laws and provisions may place certain aspects of local government structure and behavior beyond the reach of state governments. Although home rule is sometimes equated with the Cooley Doctrine, the actual structure of home rule in a state is usually somewhere between the Dillon and Cooley extremes. States regulate some aspects of local governments directly, while allowing local governments sovereignty in other dimensions.

A third aspect of sovereignty is that some states have constitutional prohibitions on special state commissions that can take over municipal functions.[19] The special commission bans were intended to protect local autonomy by curbing the ability of the states to take over important municipal functions, which are vested in democratically elected local officials.

Table 14.1 lists the dates when states adopted mandatory general incorporation acts for local governments and the dates when states adopted some form of home rule for local governments. Because of this evolution,

Table 14.1 Year of First General Law for Municipalities and First Home Rule Law, United States

State	Statehood	General Law	Home Rule
Alabama	1819	—	—
Alaska	1959	—	1959
Arizona	1912	1912	1912
Arkansas	1836	1868	—
California	1850	1879	1879
Colorado	1876	1876	1912
Connecticut	1788	1965	—
Delaware	1787	—	—
Florida	1845	1861	—
Georgia	1788	—	—
Hawaii	1959	1959	1959
Idaho	1890	1889	—
Illinois	1818	—	1970
Indiana	1816	—	—
Iowa	1846	—	1968
Kansas	1861	1859	1960
Kentucky	1792	1891	—
Louisiana	1812	1974	1974
Maryland	1788	1864	1954
Massachusetts	1788	—	—

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Table 14.1 (continued)

State	Statehood	General Law	Home Rule
Michigan	1837	1909	1909
Minnesota	1858	1896	1896
Mississippi	1817	1890	—
Missouri	1821	—	1875
Montana	1889	1922	1973
Nebraska	1867	1866	1912
Nevada	1864	1864	1924
New Hampshire	1788	1966	—
New Jersey	1787	—	—
New Mexico	1912	—	1970
New York	1788	1894	—
North Carolina	1789	1916	—
North Dakota	1889	1889	1966
Ohio	1803	1851	1912
Oklahoma	1907	1907	1907
Oregon	1859	—	1906
Pennsylvania	1787	1874	1922
Rhode Island	1790	1951	1951
South Carolina	1788	1896	1973
South Dakota	1889	1889	1963
Tennessee	1796	—	1953
Texas	1845	1876	1912
Utah	1896	1896	—
Washington	1889	1889	1889
West Virginia	1863	1936	1936
Wisconsin	1848	1848	1924
Wyoming	1890	1889	—

Source: Hennessey 2009.
Note: — = No law passed as of 2009.

which is described in more detail in the next section, by the late 19th century, almost every state had in place constitutional provisions that governed local government borrowing. Those powers varied from state to state and, in some states, from local government to local government. A critical implication of these structures for local government borrowing and insolvency was that voters and taxpayers could be held liable only for commitments that their local government made that fell within the local government's lawful authority and functions. In some cases, specific voter approval of a bond issue and related project is required.

The legal concept that governs is *quo warranto* (by what authority). Local governments could borrow only for purposes for and by methods which they were authorized to borrow; otherwise, the taxpayers were not under an obligation to repay the money. This would have enormous implications for the dynamic development of local government finances, to which we now turn.

Historical Context

The origins of state system intervention in local government finances lie deep in American history. Understanding changes in the institutional framework of local government finance in 20th-century America is not possible without understanding the 19th-century framework. Therefore, this section covers both the colonial period to the late 19th century and the late 19th century to the present.[20]

From Colonies to the Late 19th Century

During the colonial period, cities enjoyed substantial autonomy from colonial governments. Fourteen colonial cities were given royal charters. The charters granted extensive economic powers to cities, as well as modes of governance that were not transparently democratic. Albany, for example, possessed a monopoly on the fur trade of western New York. Teaford (1975) argues that, following contemporary British practice in the colonial period, local charters were regarded as sacrosanct.[21]

The independence of local governments from state government intervention did not last after the American Revolution. States asserted their rights to regulate local governments. State governments rescinded or replaced the charters of all 14 colonial cities. In the cases of New York; Philadelphia; Norfolk, Virginia; and Newport, Rhode Island, states replaced city charters over the objections of the existing city governments. In the landmark 1819 Supreme Court decision about the nature of corporate charters, *Dartmouth v. Woodward*, Justice Story distinguished public corporations from private corporations. The case is famous for articulating the principle that corporate charters are contracts and that states are bound to honor their contracts. But the decision explicitly recognized that states could change the charters of public corporations, including municipal charters, at will.

There was never a period after winning its independence from Britain when local governments in the United States were presumed to be independent from state governments. Dillon's "rule" that all local governments are creatures of the state was not a ruling handed down by Dillon, but a simple recognition of the facts on the ground. While states varied widely in how they structured and regulated local governments, certain patterns can be observed over time in state-local government relationships with regard to finance and administration. These changes began in the 1840s and continue to the present day.

In the early 1840s, eight states and the Territory of Florida defaulted on their sovereign debts. Five of the states eventually repudiated all or part of their bonds, and several other states renegotiated with bondholders.[22] In the aftermath of the default crisis, almost half of the existing states wrote new constitutions. Eleven of the 12 new constitutions contained "procedural debt restrictions." These procedures allowed state governments to borrow money, but legislatures were required to calculate the amount of new taxes necessary to finance bond repayment and to submit a referendum to the voters, in which a majority must approve the higher taxes before bonds could be issued. These "bond referendums" are common in American elections today. Although some states capped the total amount of debt that could be outstanding, most states only altered the procedure for issuing debt.

Imposing procedural restrictions on state bond issues raised the political cost of borrowing at the state level. State legislatures were now required to raise taxes before they borrowed and to obtain voter approval of the increase. In response, borrowing shifted to the local level.[23] Local governments began borrowing large amounts of money and, in the 1870s, local governments began defaulting on their debts, particularly on debts incurred to build or support railroads. States responded to the wave of local defaults by extending procedural bond restrictions to local governments. Table 14.2 lists the dates when states first extended fiscal restrictions to local governments up through the 1890s, and table 14.3 lists the dates to the present.

Table 14.2 State Constitutional Provisions Governing Local Debt and Borrowing Provisions, United States, 1841–90

State	Provision	Year[a]
Alabama	1	1875
Arkansas	1	1874
California	1	1879
Colorado	1	1876
Connecticut	1	1877
Delaware	0	n.a.
Florida	1	1868, 1875
Georgia	1	1877
Idaho	1	1889
Illinois	1	1870
Indiana	1	1851, 1881
Iowa	0	n.a.
Kansas	0	n.a.
Kentucky	0	n.a.
Louisiana[b]	1	1879
Maine	1	1868, 1878
Maryland	1	1867
Massachusetts	0	n.a.
Michigan	1	1850
Minnesota	1	1879
Mississippi	1	1875
Missouri	1	1875
Montana	1	1889
Nebraska	1	1875
Nevada	1	1864
New Hampshire	1	1877
New Jersey	0	n.a.
New York	1	1846, 1874, 1884
North Carolina	1	1876
North Dakota	1	1889
Ohio	1	1851
Oregon	1	1857

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Table 14.2 (continued)

State	Provision	Year[a]
Pennsylvania	1	1873
Rhode Island	0	n.a.
South Carolina	1	1868, 1884
South Dakota	1	1889
Tennessee	1	1870
Texas	1	1876
Utah	0	n.a.
Vermont	0	n.a.
Virginia	0	n.a.
Washington	1	1889
West Virginia	1	1872
Wisconsin	1	1848, 1874
Wyoming	1	1889

Source: The provisions in the table are taken from the 1880 and 1890 Census reports, supplemented by the constitutional texts on the National Bureau of Economic Research (NBER)/Maryland Constitution project, http://www.stateconstitutions.umd.edu.

Note: Local provisions include some type of restriction or regulation on the issue of debt by local governments. These include procedural restrictions, such as referendums, absolute dollar limits, and percentage valuation limits. n.a. = not applicable.

a. The table list a "1" if the state had any provisions, a "0" if it did not. The dates refer to the first year a state adopted a debt restriction or limitation, and subsequent years where significant changes occurred. The dates are not absolutely accurate, in the sense that they do not consider the confederate or reconstruction constitutions in southern states. Several reconstruction constitutions had debt limits, which were ignored, and interpreting those limits is problematic.

b. Louisiana wrote constitutions in 1845, 1852, 1861, 1864, 1868, and 1879, 1898, and 1913. The table refers only to the original 1845 provisions and the modifications made in 1879.

Table 14.3 State Constitutional Provisions on Local Government Debt Issue, United States

State	First year[a]	GO limits[b]	Other debt limits[c]	Procedure restrictions[d]	Other years[e]
Alabama	1901	1	1	1	1927, 1960, 1965, 1967, 1972, 1977
Alaska	1959	1	1	1	
Arizona	1912		1	1	1972, 1974, 1980
Arkansas	1874	1	1	1	1924, 1926, 1984, 1986, 1988, 1992

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Table 14.3 (continued)

State	First year[a]	GO limits[b]	Other debt limits[c]	Procedure restrictions[d]	Other years[e]
California	1879	1	1	1	1892, 1900, 1906, 1914, 1918, 1922, 1940, 1949, 1950, 1972
Colorado	1876	1		1	1888, 1972
Connecticut	1877	1			1955, 1965
Delaware	1897				
Florida	1912	1	1	1	1924, 1930, 1952, 1963, 1968
Georgia[f]	1877	1	1	1	1945, 1976, 1983
Hawaii	1959	1	1	1	1968, 1978
Idaho	1890	1	1	1	1950, 1964, 1966, 1968, 1974, 1976, 1978, 1996
Illinois	1870	1	1	1	1904, 1970
Indiana	1881	1			
Iowa	1857	1			
Kansas	—				
Kentucky	1891	1		1	1909, 1994
Louisiana	1898	1		1	1904, 1906, 1908, 1913, 1914, 1916, 1920–27, 1974, 1989, 1994
Maine	1878	1		1	1913, 1951, 1962
Maryland	1867	1	1	1	1933, 1934
Massachusetts	—				
Michigan	1850	1	1	1	1893, 1899, 1905, 1909, 1910, 1917, 1928, 1964
Minnesota	1872	1			1879, 1924
Mississippi	—				
Missouri[f]	1875	1	1	1	1905, 1945, 1960, 1974, 1988, 1990, 2002
Montana	1889	1		1	1950, 1973
Nebraska	1875	1	1	1	1920, 1972, 1978
Nevada	—				
New Hampshire	—				
New Jersey	—				
New Mexico	1911	1		1	1964, 1982, 1988, 1996
New York	1846	1	1	1	1894, 1905, 1907, 1909, 1917, 1938, 1945, 1951, 1953, 1963, 1973
North Carolina	1868	1	1	1	1936, 1946, 1962, 1971, 1973, 1976, 1977, 1986
North Dakota	1889	1	1	1	1920, 1981

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Table 14.3 (continued)

State	First year[a]	GO limits[b]	Other debt limits[c]	Procedure restrictions[d]	Other years[e]
Ohio	1912	1	1		1974
Oklahoma	1907	1	1	1	1960, 1962, 1963, 1957,1958, 1963, 1963, 1966, 1976, 1986, 1998
Oregon[f]	1857	1		1	1910, 1912, 1916, 1920
Pennsylvania	1874	1		1	1911, 1915, 1918, 1951, 1961, 1966, 1969
Rhode Island	1951	1		1	1986
South Carolina	1896	1		1	1977, plus
South Dakota	1889	1		1	1954
Tennessee[f]	—				
Texas	1876	1	1	1	1904, 1909, 1933, 1947, 1956, 1958, 1960, 1962, 1965, 1966, 1967, 1969, 1970, 1978, 1981, 1982, 1987, 1989, 1997, 1999
Utah	1895	1		1	1911, 1975, 1991
Virginia	1902	1	1	1	1928, 1971, 1981
Washington	1889	1	1	1	1952, 1972, 1981
West Virginia	1872	1		1	1950
Wisconsin[f]	1872	1		1	1909, 1929
Wyoming	1889	1		1	1919, 1953, 1961

Source: NBER/Maryland Constitution project, http://www.stateconstitutions.umd.edu.
Note: — = State has no constitutional provision regarding local borrowing.
a. The "First year" is the first year that state provision with respect to local governments appear.
b. "GO limits" are 1 when the state has some limit on the amount of general obligation debt that local governments can issue. These limits can be absolute dollar amounts or relative limits (percentage of assessed value, percentage of tax revenue, and so forth).
c. "Other limits" are 1 when the state government limits the amount of other types of debt that local governments can issue, largely revenue bonds and forms of nonguaranteed debt.
d. "Procedural restrictions" are 1 when local governments are required to go through a specific procedure to approve a debt issue, like a bond referendum or a super majority.
e. "Other years" are either new constitutions or amendments to the constitution that change the nature of the constitutional provisions.
f. Information for these states may be incomplete because of problems with the constitutional texts.

By the end of the 19th century, most state constitutions had some provisions that regulated the fiscal behavior of local governments. Prominent among the provisions were requirements that local governments hold referendums to approve tax increases before they borrowed, and limits on the total amount of taxation, spending, or borrowing local governments could engage in.

As described in the previous section, some states also implemented a major institutional change in the 1850s, when state constitutions began to mandate that state legislatures pass "general incorporation acts" for creating municipal (and other local) governments. A general incorporation act provided a standardized form of corporate charter, which local governments could implement through simple administrative procedures without the explicit approval of the state legislature.

There are two important implications of the general incorporation acts. First, the active involvement of state legislatures was taken out of the process of creating and structuring local governments. Second, in principle, every municipal charter would be exactly the same within a state—the charter is included in the general incorporation act. The general incorporation acts represented a major step in the creation of stable political institutions governing local governments, clarifying rules, and minimizing the extent of state-level political discretion over local institutions. Again, some states did not adopt general acts.

The problem with the general acts was the one-size-fits-all nature of the chartering procedure. Local governments varied considerably in size and circumstances. Beginning in the 1870s, states began inserting "home rule" provisions in their constitutions, allowing some or all local governments to structure their own charters within the limits laid out by the state government. These home rule acts are better thought of as "liberal general incorporation acts," similar to the new incorporation acts that states began creating for business corporations in the 1880s. The home rule charters were more liberal in allowing local governments to choose between a wider set of options for structuring their charters and governments. The home rule reforms were consistent with the desire to limit state political interference with local institutions. Within the broader limits established under home rule, local governments were essentially independent.

It must be emphasized, however, that home rule provisions in constitutions and home rule legislation passed by state legislatures typically include restrictions on local governments as well: limits on local government borrowing, spending, and taxation; restrictions on the kinds of activities that local governments could engage in; and restrictions on the form of administration a local government could adopt. These constitutional and legislative provisions are a central part of the passive rules governing local government borrowing. Table 14.1 provides information on the dates states banned special incorporation for local governments, mandated general incorporation for local governments, and allowed home rule.

The systems in place by the late 19th century in all states were passive. There was no active monitoring of local government fiscal conditions by state governments, nor were there any mandated actions that state governments took when a local government got into fiscal straights. The systems worked fairly well because they were embedded in two larger sets of social institutions and processes that actively monitored and disciplined local governments: citizens and bond markets. State constitutions and laws set the parameters within which local governments could operate. Both citizens and bond markets could use those parameters as a way to discipline local governments through the voting booth, courts, and markets. Individual citizens could, and did, bring cases against local governments in the courts when they felt that their local government had overstepped its authority. Bond markets could discipline local borrowing through interest rates and bond ratings. So even though the state insolvency system was passive, in the sense that the state did not actively monitor or regulate local borrowing, the system enabled active monitoring of local governments by citizens and markets. The system in place in the late 19th century was far from perfect, however, and subsequent institutional changes would sharpen the ability of both voters and markets to discipline local governments.

The various systems seem to have worked well, at least in a comparative context, as measured by the size of local government borrowing relative to state and national borrowing. Table 14.4 lists government debt by level of government—national, state, and local—for selected dates from 1838 to 2002. At the turn of the 20th century, local government debt was larger than national and state debt combined. American local governments were leaders in infrastructure and education investments. They played a key role in financing the emergence of a modern industrial economy in the United States.[24]

Private and Public Institutions from the Late 19th Century to the Present

The wave of local government defaults in the 1870s led many states to require local governments to hold bond referendums to authorize local government borrowing that obligated the general funds of the local

Table 14.4 Government Debt by Level of Government, Nominal Amount, and Shares, United States, 1838–2002

Year	State debt (US$ million)	Local debt (US$ million)	National debt (US$ million)	State share (%)	Local share (%)	National share (%)
1838	172	25	3	86.0	12.5	1.5
1841	190	25	5	86.4	11.4	2.3
1870	352	516	2,436	10.7	15.6	73.7
1880	297	826	2,090	9.2	25.7	65.0
1890	228	905	1,122	10.1	40.1	49.8
1902	230	1,877	1,178	7.0	57.1	35.9
1913	379	4,035	1,193	6.8	72.0	21.3
1922	1,131	8,978	22,963	3.4	27.1	69.4
1932	2,832	16,373	19,487	7.3	42.3	50.4
1942	3,257	16,080	67,753	3.7	18.5	77.8
1952	6,874	23,226	214,758	2.8	9.5	87.7
1962	22,023	58,779	248,010	6.7	17.9	75.4
1972	59,375	129,110	322,377	11.6	25.3	63.1
1982	147,470	257,109	924,600	11.1	19.3	69.6
1992	369,370	584,774	2,999,700	9.3	14.8	75.9
1997	456,657	764,844	3,772,300	9.1	15.3	75.5
2002	642,202	1,042,904	3,540,400	12.3	20.0	67.8

Source: Wallis 2000.

government (table 14.2). Two institutional responses in the late 19th century, one private and one public, came to play a much larger role in the market for local debt in the late 19th and early 20th centuries and continue to be important institutions in modern-day American local government finance.

The private institution was the bond counsel.[25] The prevalence of *quo warranto* defenses by taxpayers and local governments in default on their bonds led the intermediaries in the bond market to require assurance as to the valid, binding, and enforceable nature of the bonds. Financial houses that marketed local government bonds began to require legal assurance that the bonds were authorized in accordance with the law and that they were valid, binding, and enforceable agreements of the local governments. This function was performed by a bond counsel that was retained by the issuer to render a legal opinion to such effect upon which bondholders could rely.

Almost all local government bonds today come with extensive disclosure documents[26] about the nature of the bond issue, the revenues available for its payment, other information that an investor would find important to making an investment decision, and a bond counsel opinion. The bond counsel does not provide private insurance for public debt, since a bond opinion does not address whether the local government borrower would be unable to or might refuse to honor its debts. The bond counsel opinion typically addresses the lawful issuance of the bonds, the inclusion in the official statement of an accurate description of the bonds, the nature of the local government's payment obligation, and whether interest paid on the bonds is exempt from federal income taxation.

The public institutions that developed were the special district (also known as special governments, special funds, and special purpose vehicles) and revenue bonds. As local governments were increasingly required to hold bond referendums to authorize bond issues, more special purpose local governments, which provided a function such as water, sewerage, irrigation, and transportation, began to develop. Geographically, these special districts often spanned several existing local governments and were sometimes gerrymandered, so that a majority of the voters in the district benefited from the function that the special district provided and, therefore, would support a bond issue (and higher taxes or user fees) at a bond referendum, if one was required by the laws of the particular state.

Revenue bonds were similar in effect to the special district. Revenue bonds did not obligate the general funds of a local government. General obligation bonds, or "GO" debt, are typically subject to the referendum procedure. In contrast, revenue bonds were to be paid from specific revenue sources. Sometimes these revenues were connected to a specific function of the government, such as user fees for water service being used to pay bonds that financed the water system, but sometimes the revenues were simply a distinct revenue source dedicated to bond service.[27] Courts in many, but not all, states held that revenue bonds were not subject to the debt procedures that required bond referendums, since the general taxpayer was not obligated to service the debt.

The development of revenue bonds was less a way to circumvent state debt limits and procedures than a method of linking the beneficiaries of the project that the bond is to finance with the cost of project finance and the sources of payment.[28] By linking user-paid fees and taxes with financing cost, the revenue bonds were able to address the challenges facing the states in the early 19th century—statewide voters in a democratic system were unlikely to vote for broad taxation to finance a project that benefits only a location-specific population. The off-budget financing of railroads and canals in the early 1800s was a way of addressing this issue.[29] But those arrangements encumbered taxpayers with contingent liabilities that ultimately became due, and the states eventually defaulted.[30] The state constitutional amendments aimed at resolving contingent risks did not completely address the disconnect between benefits and costs. The revenue bond instruments in the late 1800s solved the problem of linking infrastructure benefits to willingness to pay. Revenue bonds may be outside the state debt limitations but are subject to their own sustainability criteria.

As the number and types of local governments and the types of local government bonds proliferated and became more complex, the role of bond counsel grew in importance in order to determine for investors whether a local government was legally authorized to issue a particular bond offering and had complied with state law authorization requirements.[31]

States continued to adjust the constitutional and legal institutions governing local governments in the early 20th century (table 14.1). The next round of institutional changes, which began in the 1930s in response to the stock market crash in 1929 and the depression that followed, involved two new national laws. The federal Securities Act of 1933 and the Securities and Exchange Act of 1934 introduced broad regulations of securities markets in such areas as disclosure, fraud, and dealer-broker registration.[32] Congress perceived that full and fair disclosure to investors, fair and efficient markets, instilling investor confidence in those markets, and assisting the process of capital formation were fundamental reasons to regulate securities and securities markets.[33]

Unlike private stocks and bonds, the securities issued by state and local government are generally excluded from the regulations of the 1933 and 1934 acts. The exception comes in the case of fraudulent activities. Direct federal regulation of the process by which state and local governments raise funds to finance their government activities would have placed the federal government in the position of gatekeeper to the financial markets for state and local governments. This would have undermined long-standing concepts of state sovereignty and local voter sovereignty. Disclosure requirements for both municipal and corporate securities are essential to the appraisal of risks and returns by investors. However, federal law does not dictate the types of disclosures required by state or local governments.

The second new development in the Great Depression was the enactment of Chapter 9 of the Bankruptcy Code in 1937. The motivation for the code was to resolve the holdout problem in negotiations between local governments and their creditors.[34] During the wave of defaults in the Great Depression, protracted negotiations between millions of investors and municipal debt issuers had proven to be costly and inefficient. In the absence of well-understood and enforceable procedures, a single investor or a group of individual investors can prevent the debt restructuring agreement reached between the debtor and majority of investors. The Chapter 9 procedures enabled a debt restructuring agreement between the majority of bondholders and the debtor that overcome the objections of individual minority investors through the power of the court.[35] Chapter 9 not only provides ex-post legal procedures for resolutions, but also frames expectations of investors and debtor on potential risks of default.

What Chapter 9 does not do is violate the sovereignty of local voters. Chapter 9 filings have strict conditions, framed by the U.S. Constitution, that grant states the power to manage their political subdivisions. States cannot be forced to allow their local governments access to Chapter 9 procedures, as noted earlier. Federal bankruptcy courts cannot force local governments to raise taxes, cut expenditures, or sell assets, because those are actions of local governments that can only be imposed by voters. Chapter 9 exists to coordinate the negotiation process between local governments and their creditors. Chapter 9 is not a legal instrument that creditors can use to force local governments to repay their debts. As shown in chapter 8 by De Angelis and Tian (2013) in this volume, Chapter 9 is rarely used. From 1937 to the present, there were roughly 600 Chapter 9 cases. From 1980 through 2009, an average of fewer than 8 cases were filed annually nationwide.[36]

Both institutional innovations in the 1930s were implemented by the national government, but it would be a mistake to think of these changes as national regulation of local government debt issuances. Securities market regulation directly affected private actors, such as brokers and dealers, in the market for local government debt, not the public actors (although antifraud provisions do affect public debtors). However, both state and local governments are indirectly affected by regulations that impact the municipal bond market.

The market for local government debt continued to evolve during the 20th century. The last major institutional change was the establishment of the Municipal Securities Rulemaking Board (MSRB).[37] The MSRB was created by Congress in 1975 to provide oversight and regulation of broker-dealer firms engaged in the municipal securities business. The MSRB does not regulate state or local governments.[38] The Dodd-Frank Act recently expanded its regulatory authority to cover municipal advisors. Some MSRB rules have resulted in reduced transaction costs and increased information flows.[39]

A number of industry groups have also contributed to improvements in disclosure by state and local governments. For example, the Government Finance Officers Association and the National Federation of Municipal Analysts have developed many municipal bond disclosure recommendations that have become accepted industry practice. Most states and large local governments follow the Generally Accepted Accounting Principles for state and local governments established by the Governmental Accounting Standards Board.[40]

Most of the institutional changes in the 20th century that influence local government creation and repayment of debt are directed at the market for local government bonds, not the governments that issue the bonds. The insolvency systems that developed in the United States are primarily passive systems. Most states do not actively regulate or monitor local governments. Each state has different rules for what local governments can do, how much they can tax, how they borrow, and, in general, how much independence from state control they have. As a result, private investors in local government bonds need to be aware of the legal powers that a local government has before they invest. In the simplest terms, if a local government does not lawfully authorize a bond, the bond is void *ab initio* (from the beginning), and the local government does not have a legal obligation to repay the bond. Voters and taxpayers are liable only for the lawfully issued obligations of the local government. This does not preclude bondholders from pursuing legal actions against fraudulent activities, but owners of a bond cannot enforce the debt obligations if the bond is void *ab initio*.

Shifting the liability for ensuring that a local government has the authority to issue debt and the types and amount of revenues available to service debts from the public to the private sector occurred gradually during the late 19th century. The shift was the result of the unique development of American federalism and is both historically rooted and path dependent. The outcome, however, was to create incentives for private markets to actively monitor and discipline local government borrowers. The institutional changes that followed in the 20th century, several of them originating in the national government, are not directed at the behavior of local governments but, instead, are intended to make information flows in the private capital markets for local government operate more effectively.

This does not mean that all states have passive insolvency systems, however. In the next sections, we consider the development of active systems in a small number of states in the late 20th century.

State Intervention and Monitoring of Local Governments

In legal and constitutional terms, states play the dominant role in structuring local governments and managing municipal insolvency. But the source and scope of local government powers have long been subject to controversy and change.[41] As seen, actual practices fall between two extremes of Dillon's Rule and the Cooley Doctrine.[42] A few states actively monitor local governments on an ongoing basis and have institutions in place to deal with local government financial crises and insolvency. This section begins our examination of those states. We want to emphasize, however, that these states represent a minority of the states; they are not "typical."

The emergence of active fiscal monitoring began with North Carolina in 1931, but it appears that North Carolina was ahead of other states.[43]

Adoption of systems in other states was motivated by local fiscal crises in the 1970s. The well-publicized fiscal crises of New York City and Cleveland had national influence beyond New York and Ohio, serving as a "wake-up call" for other states.[44] Florida enacted its Local Government Financial Emergencies and Accountability Act in 1979.[45] Ohio enacted a comprehensive municipal fiscal emergency statute in 1979, as well.[46] In the 1980s, after years of decline of western Pennsylvania communities, Pennsylvania enacted a Municipalities Financial Recovery Act to assist distressed local governments.

The 1970s was a period of slow economic growth and recurrent crises, like the first OPEC (Organization of the Petroleum Exporting Countries) oil embargo of 1973. The 1970s and 1980s were a period of substantial reform in state finances, as well, including the introduction of rainy day funds and tax and expenditure limitations and modifications of state constitutions to increase the flexibility of debt restrictions to explicitly exclude revenue bonds from the limit.[47]

Active state regulation of local government fiscal activity involves three parts: monitoring, crisis definition, and intervention. Most states require local governments to adopt standard accounting standards (which are not necessarily those promulgated by the Governmental Accounting Standards Board) and to regularly file reports on financial activity with a state agency.[48] Few states actually do much with the information, however. Research by Mackey (1993) and Coe (2007) suggest that as of 2003 only 17 states actively monitored local finances on a regular basis.

Of the 17 states that actively monitor local finances, 9 actually have a system in place to predict whether local governments are headed for a fiscal crisis. Table 14.5 lists the states and their intervention systems. States in the table are ranked by the level of activity they regularly exhibit. The first column, "Coe Predict," has a 1 if states attempt to predict local fiscal conditions. The second column, "Coe Intervene," has a 1 if the state has in place policies for intervening in local government affairs. These nine states have the most active regulation of local fiscal activity. We examine three of these states, North Carolina, Ohio, and Pennsylvania, in the next section of the chapter.

The third column, "Kloha Monitor," has a 1 if the state monitors local activity in any way at all. Kloha, Weissert, and Kleine (KWK) (2005)

Table 14.5 State Monitoring of Local Fiscal Conditions, Home Rule, and Local Debt Restrictions, United States

State	Coe predict	Coe intervene	Kloha monitor	Kloha early warning	Honadle formal	Honadle none
States that monitor local fiscal conditions and attempt to predict fiscal crisis						
Florida	1	1	1	1	1	0
Kentucky	1	1	1	0	0	0
New Jersey	1	1	1	1	1	0
New Mexico	1	1	1	0	1	0
North Carolina	1	1	1	1	1	0
Ohio	1	1	1	1	1	0
Pennsylvania	1	1	1	1	1	0
Maryland	1	0	1	1	0	0
New Hampshire	1	0	1	1	0	0
States that monitor local fiscal conditions but do not predict fiscal crisis						
Alaska	0	0	1	0	1	0
Connecticut	0	0	1	0	0	0
Illinois	0	0	1	0	0	1
Massachusetts	0	0	1	0	0	0
Michigan	0	0	1	0	1	0
Nevada	0	0	1	0	0	1
New York	0	0	1	0	0	0
West Virginia	0	0	1	0	1	0
States that neither monitor local fiscal conditions, predict fiscal crisis, nor intervene in a fiscal crisis						
Alabama	0	0	0	0	0	1
Arizona	0	0	0	0	0	0
Arkansas	0	0	0	0	0	0
California	0	0	0	0	0	0
Colorado	0	0	0	0	0	0
Delaware	0	0	0	0	0	0
Georgia	0	0	0	0	0	1
Hawaii	0	0	0	0	0	0
Idaho	0	0	0	0	0	0
Indiana	0	0	0	0	0	1
Iowa	0	0	0	0	0	0
Kansas	0	0	0	0	0	1

(continued next page)

Table 14.5 (continued)

State	Coe predict	Coe intervene	Kloha monitor	Kloha early warning	Honadle formal	Honadle none
Louisiana	0	0	0	0	0	1
Maine	0	0	0	0	0	1
Minnesota	0	0	0	0	0	0
Mississippi	0	0	0	0	0	0
Missouri	0	0	0	0	0	1
Montana	0	0	0	0	0	1
Nebraska	0	0	0	0	0	0
North Dakota	0	0	0	0	0	1
Oklahoma	0	0	0	0	0	1
Oregon	0	0	0	0	0	1
Rhode Island	0	0	0	0	1	0
South Carolina	0	0	0	0	0	1
South Dakota	0	0	0	0	0	1
Tennessee	0	0	0	0	1	0
Texas	0	0	0	0	0	0
Utah	0	0	0	0	0	1
Vermont	0	0	0	0	0	1
Virginia	0	0	0	0	0	1
Washington	0	0	0	0	0	0
Wisconsin	0	0	0	0	0	1
Wyoming	0	0	0	0	0	1

Sources: Coe 2007; Honadle 2003; Kloha, Weissert, and Kleine 2005.

conducted a phone survey of all 50 states to determine whether the states had any monitoring system in place.[49] KWK also asked whether the states had an "early warning" system in place. If KWK report that the state did, column 4 reports a 1 for "Kloha Early Warning." Some confidence in the survey methodology can be found in the fact that KWK find nine states with early warning systems, and they are all states that Coe finds to have prediction systems.

The next element is the process by which a "fiscal crisis" is determined. Honadle (2003) surveyed all 50 states to determine how and whether states had procedures for determining when a crisis was occurring. She found that 11 states had formal definitions of a fiscal crisis and 20 states had no definition. In between the extremes, 14 states had working definitions of a crisis that had not been formalized, and 8 states relied on local governments to define a local fiscal crisis.[50] The table reports a 1 if the state had a formal definition, "Honadle formal." Likewise, the table reports a 1 if the state had no definition under "Honadle none." The states with informal definitions are not indicated in the table.

The final step is intervening or assisting local governments that are in crisis. Coe (2007) found that seven states had active intervention systems in place. These systems worked pre- and postcrisis. States can also offer assistance to local governments. Mackey found that 13 states had statutory provisions for providing state assistance, and an additional 6 states had provided assistance on an ad-hoc basis. Mackey's sample includes 41 states, 9 of which did not respond. Mackey's results have not been included in the table because of the problem with missing observations.

The arrangement of the table reflects the intensity with which states monitor and intervene in local fiscal affairs but not the extent to which they assist local governments that are in trouble. The first panel of the table includes all of the nine states that monitor local fiscal conditions and attempt to predict fiscal crisis. Seven of these nine states also have systems in place to intervene in local finance. These states have the most active monitoring and intervention systems. The second panel includes the states that monitor local fiscal conditions but do not predict fiscal crisis. The final panel includes those states that do not monitor local fiscal conditions, predict fiscal crisis, or intervene in a fiscal crisis.[51] These states have completely passive systems, at least ex ante, and most states fall into the lower panel. They do not monitor local fiscal conditions nor do they have any systematic plans in place for intervening in or assisting local governments. This does not mean that states in the lower panel are unwilling to assist local governments. They may well be, but they do not have institutional arrangements in place to do so. To the extent that these states are active, it is only in an ex-post sense, after a crisis has already developed.

Section six of the chapter does some simple empirical tests to determine whether fiscal behavior in these three types of states differed significantly over the late 20th century. We find that they did. But first, we want to look more carefully at three of the most active states, North

Carolina, Ohio, and Pennsylvania, to get a better idea of what "active" monitoring and intervention in local government actually means.

State Intervention Cases

This section presents a more in-depth review, up to 2010, of the state intervention system in North Carolina, Ohio, and Pennsylvania—chosen from the active end of the state intervention spectrum. The intervention systems in the three states were put in place to respond to the debt stress of their respective local governments. However, the crisis response differs across the three states. Fiscal monitoring and insolvency resolution concern the source and scope of local government powers, so home rule provisions are critical because they grant local governments the levels of self-government rights, limit state intervention power, and, consequently, determine how states can intervene in local affairs.

North Carolina is the most active state manager of local finance in the United States.[52] Ohio, a home-rule state, has a fiscal watch program to provide early warning and a fiscal emergency program to deal with entities mired in fiscal crises, but the state lacks broad intervention power. With strong home rule limiting the power of the state's intervention, Pennsylvania has used a state-appointed coordinator to provide a fiscally distressed local government with a financial recovery plan; however, the local government can reject the adoption of the plan.[53]

During the Great Depression, North Carolina suffered from the second-largest number of municipal bond defaults in the United States.[54] The Local Government Commission (LGC) was created by the state legislature in 1931 to control local debt and assist fiscally distressed municipalities.[55] Ohio's original municipal fiscal emergency law was enacted in 1979 in response to the financial crisis in Cleveland. After years of struggle in a recession and a massive auto industry layoff, in 1978, Cleveland became the first major American city to default on its debts since the Great Depression.[56] In 1987, when communities in western Pennsylvania were hit by job losses due to the decline of the steel industry, the state legislature enacted the Municipalities Financial Recovery Act, known as Act 47, to assist fiscally distressed municipalities.[57] Designed for small municipalities, Act 47 could not address the financial difficulties experienced by Philadelphia when it reached the brink of bankruptcy in 1991.[58] Additional state assistance was thus provided through new legislation that created the Pennsylvania Intergovernmental Cooperation Authority (PICA).

The North Carolina constitution enables the state legislature to define the powers and duties of municipalities. According to the state constitution, the state can destroy, restructure, and create any of its subdivisions.[59] The state constitution, therefore, placed almost entire control over municipalities in the hands of the state. Intergovernmental relationships in North Carolina embody a strong version of Dillon's Rule. In this constitutional context, North Carolina's LGC possesses strong intervention power in local financial management when the local fiscal situation starts to deteriorate.

The LGC can issue orders to raise taxes or other revenues to meet debt payment.[60] These orders are as enforceable as those issued by local officials. The LGC, under the State Treasurer, is actively involved in almost all phases of local financial management. The LGC approves almost all local debt issues and monitors local fiscal conditions. The state has the authority to take over the financial management of local governments that do not comply with the LGC directives, experience fiscal stress, or fail to report financial operations on a timely basis.[61]

The LGC approves almost all traditional types of municipal debt, including general obligation bonds, revenue bonds, installment and lease purchase obligations, and the use of swap agreements. The LGC uses indicators to measure debt affordability such as per capita debt, debt as a percentage of assessed valuation, annual debt service payments as a percentage of the general fund budget, and the fiscal health of enterprise operations and comparison of user charges levied.[62] After approving debt issues, the State Treasurer's office handles the sale and transactions of all local debt and monitors debt servicing.[63]

The North Carolina approach to financial oversight and monitoring is proactive. The LGC monitors the finance of about 1,230 local governments and public authorities through annual reviews.[64] The LGC requires an independent auditor, mandates standard audit contracts, approves the selection of local government auditors and audit contracts, and permits final payment to an auditor only after approving the financial report.[65] If financial problems are discovered, the LGC sends a letter to the local entity, expressing concerns and offering suggestions for improvement.

Local units that receive a letter are required to report a detailed plan of corrective actions to resolve the problems.[66]

In contrast to North Carolina, Pennsylvania's constitution prohibits the state legislature from enacting laws that regulate the affairs of a specific municipality. It also prohibits the state from establishing any commission with the power to intervene in municipal functions or delegating such powers to any commission.[67] In order to comply with this constitutional provision, the state cannot unilaterally intervene in a municipal insolvency. State participation must be conditional on local agreement or assent.[68]

The implementation of Act 47 in 1987 to assist fiscally distressed municipalities is administered by the Department of Community and Economic Development (DCED). Act 47 enables the DCED to compile fiscal data of municipalities to monitor their fiscal condition and determine their distress status, using 11 indicators.[69] Any single indicator can trigger a declaration of distress status by the DCED.

Once a municipality is declared financially distressed, the DCED appoints a coordinator responsible for developing and implementing a financial recovery plan.[70] Act 47 grants municipalities the right to reject such a plan. When labor unions challenged the constitutionality of Act 47,[71] the court held that the state-appointed coordinator did not constitute a special commission and that municipalities retained their decision-making authority through their right to reject the plan.[72] The ability of municipalities to reject the state plan is a critical result of the general law provision: the state cannot treat local governments differently without their permission.

The state created a special commission, the PICA, in 1991, to address the financial problems of near-default in Philadelphia. The PICA was created under the intergovernmental corporation clause in the state constitution. The state uses financial incentives to encourage local cooperation and to punish those who refuse to cooperate with the state by withholding state funds.[73] The PICA weathered legal challenges from unions.[74] The court held that the PICA did not interfere with municipal powers because the city voluntarily entered into a cooperative agreement with the PICA.[75] In a manner similar to Pennsylvania, the Ohio Constitution sets forth that "Municipalities shall have authority to exercise all powers of local self-government."[76] Furthermore, the constitution prohibits the state from adopting special legislation for a specific municipality.[77] As a result, in response to Cleveland's fiscal crisis in 1979, Ohio adopted a general statute that governs a wide range of municipalities: cities, villages, counties, and school districts.

The 1979 local emergency law created the fiscal emergency program and institutionalized the Financial Planning and Supervision Commission to assist fiscally distressed local governments. The State Auditor can place a local government in the emergency program if the latter crosses the threshold of any of six financial conditions relating to arrears, fund deficits, liquidity, default on debt, payroll arrears, and tax transfers.[78] The law was amended in 1996 to add a fiscal watch program providing early warning to faltering entities whose fiscal conditions approach emergency status.[79]

After the State Auditor declares a local government in fiscal emergency, a financial planning and supervision commission is formed. The municipality must submit a financial recovery plan for commission approval. The commission then ensures the timely implementation of the plan. The financial recovery plan lays out substantive fiscal adjustments to restore financial stability, eliminate fiscal emergency conditions, and avoid future reoccurrence. Five out of seven voting members of the commission are locally based, including two local officials and three locally nominated members. The state cannot mandate changes; instead, it recommends strategies and oversees the implementation.[80] The Ohio state intervention system is characterized by weak state intervention power.[81]

The commission has broad authority to make recommendations regarding all financial matters, including cost reductions or revenue increases, making and entering into all contracts and agreements necessary to the performance of its duties, and ensuring a balanced budget and its implementation. The commission is empowered to review all revenue and expenditure estimates, and to approve and monitor the monthly levels of expenditures and encumbrances consistent with the financial plan. The commission also reviews the amount and purpose of any debt issues, and provides technical support on the structure and terms of debt obligations.[82] The termination of an entity's fiscal watch status occurs when either the warning conditions no longer exist, as determined by the State Auditor, or fiscal conditions continue to deteriorate. In the latter case, the State Auditor may declare a fiscal emergency.[83] Local governments' participation in the fiscal emergency program averaged 5.1 years.[84]

Ohio does not actively formally monitor local governments, unless a government enters the fiscal watch or emergency program.[85] The absence of monitoring is well illustrated by the fact that most fiscally distressed municipalities bypassed fiscal watch and directly entered into the fiscal emergency program. Early detection of fiscal problems is on a voluntary basis. Municipalities, however, may discover they are in trouble later than might be optimal. The state intervention system in Ohio is reactive rather than proactive. In practice, most cases are initiated by local entities through request, although the fiscal emergency or watch program could also be triggered by the Governor or the State Auditor.[86]

North Carolina, Pennsylvania, and Ohio offer revealing insights into the nature of active state intervention into local fiscal affairs. If a state constitution recognizes the independent fiscal power of local governments, the ability of the state in the fiscal adjustment process of the local government is limited. Special legislative bans prohibit legislation targeted at a specific municipality. Creation of financial control boards may not be feasible if special commissions are prohibited. Local consent may be required for state intervention, and states need to provide incentives for local cooperation.

North Carolina is an outlier at the very active end of the spectrum of state and local relationships, even in this small sample of three states. In most states, North Carolina's aggressive intervention in local government affairs would be unconstitutional, given their state constitutional frameworks. Since local governments, in general, have been successful in borrowing to finance infrastructure during the 20th century, it does not appear that North Carolina's active state intervention has broad relevance to other states in efforts to achieve local fiscal responsibility.

Empirical Results

In order to determine whether the insolvency systems shown in table 14.5 had a significant impact on local government finance, we performed a simple set of difference-in-differences estimates on state and local fiscal activity in 1972, 1992, and 2007. Data for those years (and others) are readily available from the U.S. Census of Governments. Data for 1992 and 2007 come after states began active monitoring and intervention programs.

We took three basic measures of state and local fiscal behavior. "Total revenue" is total revenue from "own" sources for state governments, all local governments, and state and local governments combined. Own revenue is revenue collected directly by the state or local governments and does not include revenue from intergovernmental grants. "Total expenditure" is total "direct" expenditure. Again, direct expenditure excludes expenditures for intergovernmental grants and counts only expenditures that are made by state or local governments directly. "Total debt" outstanding combines both long- and short-term debt, but for most state and local governments, the preponderant share of total debt is long-term debt.[87]

Each of these variables is measured in two ways. The first takes the local share of the combined state and local total. The local share of revenue is local government own revenues divided by combined state and local own revenues (excluding any grant revenue from the federal government). Local shares of expenditure and debt were calculated in a similar manner. The other measure is revenues, expenditures, and debt per capita. These are measured in nominal terms for each year (the differencing takes care of the changes in price levels).

Table 14.6 reports the difference-in-differences results for the relative size of local fiscal activity in the state and local fisc.[88] The first panel of the table gives the local share of combined state and local revenues, expenditures, and debt for each of the three years: 1972, 1992, and 2007. The first column gives the average share for the "Predict States," the states that Coe (2008) indicates are predicting whether a fiscal crisis will occur. The second column gives the average share for the "Monitor states," which are the states that Kloha, Weissert, and Kleine (2005) find actively monitor local finances but do not attempt to predict or intervene in local affairs. The third column gives the average local share for the "Control states" (the untreated states), which do not monitor or predict. The fourth column gives the average local share for "All states."

When interpreting the numbers, it is worth noting that the raw data are on own revenues and expenditures for each level of government.

Table 14.6 Difference-in-Differences Estimates, Local Share of State and Local Totals, United States

Local share	Predict states	Monitor states	Control states	All states
1972				
Revenue share	0.411	0.433	0.426	0.428
Expend share	0.560	0.545	0.541	0.541
Debt share	0.641	0.616	0.712	0.693
1992				
Revenue share	0.387	0.379	0.398	0.393
Expend share	0.513	0.501	0.519	0.515
Debt share	0.583	0.488	0.571	0.560
2007				
Revenue share	0.411	0.385	0.397	0.397
Expend share	0.499	0.501	0.501	0.501
Debt share	0.537	0.469	0.557	0.539
	First difference 1972–92			
Revenue share	−0.024	−0.054	−0.028	
Expend share	−0.047	−0.044	−0.021	
Debt share	−0.058	−0.129	−0.141	
	First difference 1972 to 2007			
Revenue share	0.000	−0.048	−0.030	
Expend share	−0.061	−0.044	−0.039	
Debt share	−0.104	−0.148	−0.155	
	Difference-in-differences			
1972–92				
Revenue share	0.004	−0.025		
Expend share	−0.025	−0.023		
Debt share	0.083	0.012		
1972 to 2007				
Revenue share	0.030	−0.018		
Expend share	−0.022	−0.004		
Debt share	0.051	0.008		

Source: Census of Governments.

Since local governments are, in every case, net recipients of grants from the states, and grants are excluded from the "own" and "direct" categories of revenues and expenditures, local governments have a smaller share of state and local revenue than of state and local expenditures.

The second panel of the table gives the first difference of the various measures between 1972 and 1992, and between 1972 and 2007. Most of the active monitoring came online in the 1970s and 1980s, and should be reflected in both differences.

The third panel of the table gives the difference-in-differences estimates, comparing the difference in the “Predict states” and “Monitor states” to the “Control states.”

Table 14.6 illuminates two striking results.

The first is the relative decline in the local share of the state and local fisc on almost all measures over both time periods. Local revenues as a share of state and local revenues rose slightly after 1992, but on every other measure, the local fisc got relatively smaller.

The second is that the decline in the local share of debt issued occurred much more slowly in the “predict” states, although it still occurred. The change in local share of state and local debt was 8 percent higher in “predict” states than in the “control” states during 1972–92, and 5 percent higher over the longer period 1972 to 2007. This is a significant impact.

The table does not give measures of statistical significance, because the 50 states are the relevant universe. This is not a sample of states.

Tables 14.7, 14.8, and 14.9 perform similar difference-in-differences estimates for per capita revenues, expenditures, and debt for local, state, and combined state and local totals. The tables have the same format as table 14.6.

All three tables share the same striking, and unexpected, result. The “monitor” states, that is, the states that monitor but do not actively predict or intervene in local affairs, exhibit much faster growth in every measure of state and local fiscal activity.

Unlike the results in table 14.6, which show that the share of state and local borrowing is devolving to local governments in the “predict” states relative to other states, tables 14.7, 14.8, and 14.9 show that per capita revenues, expenditures, and debt are all growing faster in the “monitor” states than in the “control” or “predict” states, and this goes for both state and local governments. The effect of being a “monitor” state is about twice as large for state-level measures as it is for local-level measures. And unlike the table 14.6 results, the effect is stronger rather than weaker over the longer period, 1972 to 2007, than over the shorter period.

Table 14.7 Local Total Revenue, Expenditure, and Debt per Capita, United States, 1972, 1992, 2007

Local total	Predict states (US$)	Monitor states (US$)	Control states (US$)	All states (US$)
1972				
Revenues	280	358	298	312
Expenditures	446	636	453	489
Debt	444	690	469	512
1992				
Revenues	1,435	1,845	1,454	1,513
Expenditures	2,188	2,794	2,195	2,290
Debt	2,107	2,846	2,039	2,180
2007				
Revenues	2,449	2,829	2,300	2,412
Expenditures	4,156	4,928	4,195	4,305
Debt	3,947	4,588	3,670	3,867
		First difference 1972–92		
Revenues	1,154	1,487	1,156	
Expenditures	1,742	2,158	1,741	
Debt	1,663	2,156	1,570	
		First difference 1972 to 2007		
Revenues	2,168	2,471	2,002	
Expenditures	3,709	4,292	3,741	
Debt	3,503	3,898	3,201	
		Difference-in-differences		
1972–92				
Revenues	–2	331		
Expenditures	0	416		
Debt	93	587		
1972 to 2007				
Revenues	166	468		
Expenditures	–32	551		
Debt	302	697		

Source: Census of Governments.

Table 14.8 State Total Revenue, Expenditure, and Debt, United States, 1972, 1992, 2007

State total	Predict states (US$)	Monitor states (US$)	Control states (US$)	All states (US$)
1972				
Revenues	391	444	397	409
Expenditures	346	559	391	424
Debt	268	462	222	269
1992				
Revenues	2,302	3,365	2,233	2,427
Expenditures	2,075	2,935	2,054	2,199
Debt	1,659	3,093	1,601	1,850
2007				
Revenues	3,453	4,888	3,543	3,742
Expenditures	4,202	5,152	4,183	4,341
Debt	3,420	5,562	2,943	3,448
		First difference 1972–92		
Revenues	1,911	2,922	1,836	
Expenditures	1,729	2,376	1,663	
Debt	1,391	2,631	1,379	
		First difference 1972 to 2007		
Revenues	3,062	4,445	3,146	
Expenditures	3,856	4,592	3,792	
Debt	3,151	5,100	2,721	
		Difference-in-differences		
1972–92				
Revenues	75	1,085		
Expenditures	66	712		
Debt	11	1,252		
1972 to 2007				
Revenues	–84	1,299		
Expenditures	64	801		
Debt	430	2,379		

Source: Census of Governments.

Table 14.9 Combined State and Local Total Revenue, Expenditure, and Debt, United States, 1972, 1992, 2007

State and local total	Predict states (US$)	Monitor states (US$)	Control states (US$)	All states (US$)
1972				
Revenues	671	802	695	721
Expenditures	793	1,195	844	913
Debt	712	1,152	691	781
1992				
Revenues	3,721	5,183	3,672	3,923
Expenditures	4,264	5,729	4,249	4,488
Debt	3,766	5,940	3,640	4,031
2007				
Revenues	5,901	7,717	5,843	6,154
Expenditures	8,358	10,080	8,377	8,646
Debt	7,367	10,150	6,613	7,314
		First difference 1972–92		
Revenues	3,050	4,382	2,977	
Expenditures	3,471	4,533	3,405	
Debt	3,054	4,788	2,949	
		First difference 1972 to 2007		
Revenues	5,230	6,915	5,148	
Expenditures	7,565	8,884	7,533	
Debt	6,654	8,998	5,922	
		Difference-in-differences		
1972–92				
Revenues	73	1,404		
Expenditures	66	1,129		
Debt	105	1,838		
1972 to 2007				
Revenues	82	1,767		
Expenditures	32	1,351		
Debt	733	3,076		

Source: Census of Governments.

The impact of being a "monitor" state is economically significant. State and local expenditures per capita, for example, rose by US$8,884 between 1972 and 2007. Being a "monitor" state increases state and local expenditures by US$1,351. We cannot tell whether this is a causal effect or not. States with rapidly growing expenditures may have implemented monitoring systems, or local governments in states with monitoring systems may face lower costs of raising revenue. It is also interesting that in "monitor" states, own revenues rise faster than direct expenditures (although interpreting this result for the overall fisc depends on changes in grants from the national government, which are excluded from these numbers).

The results in these tables are only suggestive. Clearly, many things were happening in the states over this 35-year period, and no attempt was made to control for selection. Some states became "predict" or "monitor" states because they wanted to shift their fiscal structure, or perhaps because their fiscal structures were shifting for completely different reasons, so no causal interpretation should be placed on the estimates.

Nonetheless, they do show that states systematically differ along the dimension of insolvency systems and that the presence of the systems is correlated with fiscal outcomes. Of particular interest is that the local share of state and local activity increased in "predict" states between 1972 and 2002. In other words, states most actively monitor and intervene in local government fiscal matters in those states in which local governments are growing in relative importance (or local governments are shrinking at a slower rate). The association of active monitoring and a growing local share of revenues and expenditures may suggest that these states are consciously adapting institutions in a way that makes local governments more important. The interaction among institutions that govern how states regulate local taxing, spending, and borrowing with levels of state and local taxing, spending, and borrowing is a fertile area for future research.

Lessons: Market and Voter Discipline

Earlier sections of this chapter looked closely at the structure and development of the American local government insolvency system, from the early 19th century to the present, in order to draw conclusions relevant to the contemporary developing world. Because of the wide variety of American experience across time and states, several lessons can be drawn, some in conflict with each other, rather than a single set of institutional recommendations. Nonetheless, there are strong commonalities across the states.

The United States has by far the largest local government capital market in the world. In 2007, local governments issued US$225 billion in bonds, and total local government debt outstanding was US$1.5 trillion. The market works well, particularly in the context of a global comparison. Local governments borrow significant amounts of money to finance infrastructure investments and have very low rates of default.

Local governments in most states face restrictions on how they borrow and what they can borrow for and, in some states, how much they can borrow. For the most part, these restrictions are on the procedures that local governments must follow to approve borrowing and how debt service obligations are related to specific revenue sources (particularly in the case of revenue bonds).

The central feature of the American experience is the importance of ex-ante and passive insolvency systems. Only one-third of the states have a system in place for monitoring local governments, and less than 20 percent have institutions and policies that enable or require state action in the face of a local government fiscal crisis. The lack of active state programs does not mean that local government borrowing and debt servicing are not actively monitored by the larger society. Instead, it highlights how the interaction of ex-ante institutional rules, voters, capital markets, and courts play the key role in monitoring and limiting local government borrowing.

The way the systems actually work can be difficult to grasp, since it appears that local governments are offered a loophole to issue debt they do not have to repay. State laws and constitutions authorize local governments to issue debt following certain procedures. In order to protect citizen sovereignty, if a local government does not authorize its bond issues in a lawful way, the bonds are not legally binding obligations, and the local government is not obligated to pay them. Very few states, however, actually monitor local governments to prevent local governments from issuing debt in unauthorized ways. Instead, the bondholders find themselves in a position where the courts will not enforce their claims as creditors against the local government if the local government has overstepped its bounds or violated procedures for authorizing and issuing debt. As a result, the role of the bond counsel is important in assuring the lawful authorization of the bonds that is the requirement for their validity and enforceability.

The result of the framework for debt issuance has not been local governments that borrow wildly in unauthorized ways and then default, but rather a steady increase in the capacity of private capital markets to assess the creditworthiness of local governments and inform potential borrowers of the actual conditions under which local debt is issued and will be repaid. The institutional developments such as the bond counsel and MSRB all make the provision of information to private market participants more credible and transparent. The national government has not violated the sovereign powers of states to tax, spend, and borrow as they wish, nor have they impaired the ability of states to establish systems for their local governments.

Whether developing countries have strong enough public and private institutions to take advantage of passive systems is a question that cannot be easily answered. The United States developed its framework for subnational debt through a series of incremental changes in institutions over a long period of time. Establishing the legal precedent that local taxpayers were not responsible for servicing debts that were incurred in an unauthorized manner or through defective procedures was a long, drawn-out process undertaken at the end of the 19th century. Passive insolvency systems also clearly require the existence of strong and credible rule of law in order to work. Institutions in many developing countries are yet to be developed to the extent necessary to discipline and regulate both public debtors and private creditors in such a subtle way. Moreover, the system operating in one country cannot be applied without care to other country contexts. Nonetheless, it is a worthy goal to work toward creating clear interests among creditors to support strengthening both the rule of law and incentives for private market development. One part of the market process in the United States—transparency and disclosure of the credit risks of all issuers— generally would be relevant.

The passive systems establish a close relationship between borrowing and taxation.[89] As noted, most of the constitutional reforms that followed the 1840s required states, and local governments after the 1870s, to raise current taxes when they issued debt. Forcing voters and taxpayers to simultaneously raise taxes when they borrowed money led voters to pay closer attention to the benefits of the expenditures that local governments proposed. Again, this was a change at the margin that affected incentives and likely had a positive effect on the dynamics of the political economy process. A similar set of incentives was set in motion when special districts and revenue bonds became widespread at the end of the 19th century.

By formally recognizing that local governments were creatures of the states, Dillon's Rule supported the premise that local governments could borrow only when they were explicitly authorized to do so, for specific functions, and often in limited amounts. In principle, states possess the authority to unilaterally change the structure of any local government. In practice, however, Americans learned that allowing state politics to manipulate local politics was bad for democratic outcomes, so they moved toward "general" laws governing local governments. This was an institutional change that had to arise endogenously in the American setting, but it offers illustrative lessons on how an institution can be adopted organically in a developing country.

Changing the way central governments interact with subordinate governments changes the political economy dynamic among the levels of government. Allowing subordinate governments to determine their own debt and tax policies within defined limits must be paired with the obligation to raise local taxes to service those debts. Such a policy will only be self-sustaining if it applies equally (generally) to all local governments. If individual local governments can approach the central government for special treatment, or if the central government can single out individual local governments for special treatment (either positive or negative), then the incentives to create and enforce credible rules are eroded. If all cities know that the same rules equally apply to all of them, then all the cities collectively have a strong incentive to make sure that a state enforces the rules equally across all cities and that the rules work for most of the cities. The incentive to press for general and efficient rules works via the political economy incentives facing local governments. Those incentives disappear if the central government treats subordinate governments differently. General rules, and the incentives they create, cannot credibly develop if the central governments treat states and cities differently. This is one of the larger lessons developing countries can draw from the American experience.

The importance of general laws for local governments also helps explain why so few states have active insolvency systems that require states to intervene in local government finances. Ex-post intervention creates the ex-ante expectation of action. Unless the state government is willing to intensively regulate many dimensions of local political decisions, it may be better not to get involved at all on a systematic basis. In most states, local crises are dealt with on an ad-hoc basis or not at all by state governments. In contrast, as the case of North Carolina shows, strict state monitoring comes with the loss of some local autonomy.

The economic recession that began in 2008 has caused a fiscal crisis for many state and local governments in the United States. The crisis has not yet passed, and it remains to be seen whether it will engender institutional changes along the lines of the 1930s or the 1970s and 1980s. The movement toward more active state monitoring systems in the 1970s and 1980s led to more, not less, local government borrowing. Local governments with more debt are more susceptible to economic downturns, regardless of the state monitoring systems in place. What has worked well in the United States is not fixed fiscal rules, but the adoption of institutions that enable political and economic markets, voters, and capital markets, to more clearly assess the cost and benefits of government borrowing. It is hoped that institutional change in the future will continue to enhance that ability.

Notes

1. See Canuto and Liu 2010a; Liu and Waibel 2009; and Liu and Webb 2011. Many developing countries still rely on bank loans as the main source of finance. The subnational capital market remains small (see Canuto and Liu 2010a).
2. In several other federal countries, such as Brazil, Canada, and India, states and provinces have considerable political and fiscal power granted by their respective national constitutions.
3. The Eleventh Amendment reads: "The Judicial power of the United States shall not be constructed to extend to any suit in law or equity, commenced or

prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State."

4. United States Census of Governments 2007.
5. United States Census of Governments 2007. A complete census of U.S. governments is taken in years ending in 2 and 7, so the 2007 Census is the most recent complete census. Bonds issued by state and local governments are sometimes lumped together and called municipal bonds (or bonds issued by subnational governments). From 2007 to 2011, annual average issuances of total subnational bonds were about US$450 billion (data source: Thomson Reuters), and at the end of 2011, outstanding debt was US$3 trillion (Federal Reserve Board, *Flow of Funds Accounts of the United States*, June 2012, Table L.104, p. 63).
6. See Canuto and Liu (2010b) for bond issuance by subnational governments outside the United States during 2000–09. In 2009, subnational governments outside of the United States issued about US$309 billion in new bonds, while state and local governments issued US$368 billion in new bonds (Federal Reserve Board, *Flow of Funds Accounts of the United States*, June 2012, Table L.104, p. 63).
7. The terms "passive," "active," "ex ante," and "ex post" have no legal meaning; they are descriptive terms used in the chapter to help understand the nature of the way states interact with and regulate local government borrowing.
8. Chapter 9 of the bankruptcy code is for all local governments, as defined here, not just municipal (city) governments. Only 27 states allow their local governments to access the federal bankruptcy courts, and, of those 27, only 18 states allow local governments access without explicit state permission. For more on Chapter 9, see chapter 8 by De Angelis and Tian (2013) in this volume; Liu and Waibel (2009); and McConnell and Picker (1993).
9. Liu and Waibel (2009), and chapter 8 by De Angelis and Tian (2013) in this volume, with sources from Laughlin (2005) and Spiotto (2008). For recent development in states' authorization, see Spiotto (2012). Whether more or less than half the states have active systems depends on how the nine states that allow their local governments access to Chapter 9 under limited conditions are counted.
10. Chapter 8 by De Angelis and Tian (2013) in this volume, with sources from the American Bankruptcy Institute; the website of United States Courts, http://www.uscourts.gov; "Bankruptcy Basics" (2006) by the Administrative Office of the United States Courts and the American Bankruptcy Institute; the 2007 U.S. Census; http://www.abiworld.org; and Public Access to Court Electronic Records, http://www.pacer.gov.
11. Since the Civil War and the Fourteenth Amendment, the national government and federal courts have exercised control over more aspects of state and local governments, for example, in the area of compliance with civil rights laws. But relationships between state and local governments remain an area governed almost exclusively by state constitutions and state laws.

12. See Briffault 1990.
13. See Williams (1986) for a summary of the theories about the nature of local governments.
14. Dillon's Rule; Judge John F. Dillon of the Iowa Supreme Court, first authored the rule in his *Commentaries on the Law of Municipal Corporations*, shortly after the Civil War.
15. See, *Hunter v. City of Pittsburgh* (1907), a Supreme Court case; and Briffault 2008.
16. States have increased and decreased local autonomy in constitutions over time, as we will show in general terms in the next section.
17. These constitutional provisions and laws have parallels in provisions and laws that require general incorporation for business enterprises, banks, churches, or any type of corporate group.
18. Section 1, Article 13, Ohio Constitution, 1851.
19. Briffault and Reynolds 2004; Briffault 2008.
20. It is impossible to give a clear date that divides the two periods, because states varied so much in the way they interacted with and regulated local governments.
21. Teaford 1975, 79.
22. Wallis 2005.
23. See Wallis and Weingast 2008.
24. The table is taken from Wallis (2000), which also discusses the relative importance of national, state, and local fiscal activity over the entire history of the United States.
25. For the history and development of bond counsels, see Maco (2001).
26. These are similar to a corporate prospectus but are usually called an "official statement." The official statement and additional information provided by the issuer over the life of most bonds are now freely available to the public at www.emma.msrb.org and from various commercial information vendors so that investors may better evaluate credit risk on an ongoing basis. It is important to note that, unlike its authority over offerings of securities by corporate entities, the U.S. Securities and Exchange Commission currently lacks authority to mandate the contents or format of municipal disclosure documents. As a result, the financial statements included are often quite stale and sometimes do not adhere to Generally Accepted Accounting Principles, and it is difficult to compare one bond to another due to the lack of a uniform format or the inclusion of uniform information in official statements for comparable bonds.
27. Such as a hotel-motel occupancy tax being used to pay bonds issued to repair roads.
28. Today, about two-thirds of subnational debt in the United States is revenue bonds—bonds issued collateralized by the revenue streams of the project that the bond is to finance. The first revenue bond was issued in 1885 by Wheeling, West Virginia, to finance a water and gas plant. The revenue bonds became mainstream in the 1970s in the United States. (Marlin and Mysak 1991, supra note 45, at 18, at 62)

29. As noted above, bonds for such private purposes were often held invalid under Dillon's Rule, and the issuer was excused from repayment.
30. Wallis 2005.
31. In addition to bond counsel representing the interests of investors, there are other counsel involved in the debt-issuing process. Underwriter's counsel ensures that the issuer's financial condition and plans and other matters that are important for an investor to know are accurately disclosed. http://www.publicbonds.org.
32. The two federal acts draw from Maco (2001).
33. Unless otherwise noted, this section draws mainly from Maco (2001).
34. McConnell and Picker 1993.
35. For more on Chapter 9, its origins, framework, and applications, see McConnell and Picker (1993), chapter 8 by De Angelis and Tian (2013) in this volume, and Liu and Waibel (2009).
36. 1980–2008 data are from American Bankruptcy Institute; 2009 data are from the website of United States Courts, http://www.uscourts.gov.
37. Maco 2001.
38. The Exchange Act requires MSRB rules for broker-dealers and municipal advisors to be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with other persons engaged in specified market support activities, to remove impediments to and perfect the mechanism of a free and open market in municipal securities, and, in general, to protect investors and the public interest. See section 15B(b)(2) of the Exchange Act for a complete description of the scope of the MSRB's authority to promulgate rules.
39. For example, through its Electronic Municipal Market Access system, the MSRB currently provides information on more than 1.5 million state and local bond issues to the public at no charge. See http://www.emma.msrb.org.
40. Municipal accounting is not uniform. Each state determines what accounting standards they and their local governments will use. Not all use Governmental Accounting Standards Board standards (Haines 2009).
41. See Briffault 1990.
42. See Williams (1986) for a summary of the theories about the nature of local governments; see *Hunter v. City of Pittsburgh*; and Briffault (2008).
43. Compiling a good chronology of when states initiated active insolvency systems is beyond the scope of this chapter; however, it appears that there was roughly a 40-year lag after North Carolina began monitoring before another state adopted comparable institutions.
44. Cahill and James 1992; CRCM 2000.
45. Mackey 1993.
46. Mackey 1993.
47. Rodriguez-Tejedo and Wallis 2010, 2012.
48. Mackey 1993.

49. Kloha, Weissert, and Kleine 2005. Coe found that New Mexico and Kentucky also actively monitor, and they have been included as monitored, even though Kloha, Weissert, and Kleine did not.
50. Honadle 2003. The numbers add up to more than 50, because several states reported more than one definition. One of the problems with collecting information from phone surveys is that Honadle reports that North Carolina had no definition of a fiscal crisis when, in fact, North Carolina has been actively monitoring and intervening in local finances since the 1930s. We reclassified North Carolina in the table.
51. The information in the table was current as of 2003–05, when the various studies were undertaken.
52. Carter 1995; Coe 2008; Kimhi 2008; Wall 1984.
53. Coe 2008.
54. Only Florida had more municipal defaults than North Carolina (Laskey and Hall 2004).
55. Laskey and Hall 2004; Wall 1984.
56. The city defaulted on US$15 million in short-term bond anticipation notes, held primarily by six banks. The crisis of Cleveland was characteristic of local difficulties in resolving fiscal problems. Tax increases were subject to popular referendum, and, in the 1970s, the city had a lower per capita tax burden than many other major cities, such as Chicago, Detroit, and Philadelphia. For more, see Ruggeri (2008) and Pennsylvania Economy League, Eastern Division (1991).
57. Cahill and James 1991. From the passage of Act 47 in 1987 to May 2010, 26 municipalities were declared fiscally distressed under Act 47 and received state assistance. Department of Community & Economic Development, http://www.newpa.com, accurate as of May 2010.
58. Cannon 1993. According to estimates, the city's deficit is 260 times larger than the entire revolving fund of Act 47.
59. North Carolina Constitution, Article VII.
60. North Carolina General Statutes, Chapter 159, §159–36; Carter 1995.
61. Laskey and Hall 2004.
62. Marino, Woodell, and Thomas 2000.
63. The Division also provides technical assistance to municipal issuers before any applications are presented to LGC for approval. See Moore 2008.
64. See Moore 2008.
65. Coe 2007.
66. In fiscal year 2007/08, 358 letters were sent to local units regarding the issues of overall fiscal health such as fund balance level, compliance with adopted budget, working capital level in water and/or sewer funds, and compliance with various statutory requirements ("Annual Report 2008," State Treasurer of North Carolina).
67. Pennsylvania Constitution, Article 3, Section 31.

68. Pennsylvania Economy League, Eastern Division (1991); see the case study of this article
69. Section 123(a) of Act 47. Certain state funds will be withheld until municipalities provide the DCED with all required data. The indicators include a deficit over a three-year period, with a deficit of 1 percent or more in each of the previous fiscal years, expenditures exceeding revenues for three or more years, debt service default, and payroll arrears of 30 days. See Section 201 of Act 47.
70. Section 221 of Act 47. The coordinator cannot be the elected or appointed official or employee of the municipality.
71. 564 A.2d 1015 (Pa. Commw. Ct 1989) as cited by Cannon (1993).
72. Cannon 1993.
73. According to ACT 47, the state gives a municipality a loan and grant only when the municipality adopts the financial recovery plan created by the state-appointed coordinator. If the municipality refuses to adopt the plan, it has to come up with its own plan, which will be subject to DCED's examination. DCED's determination of the plan's inability to address problems will trigger punishment by the state. The state will withhold certain state funds, including grants, loans, entitlements, and payment from the state or any of its agencies.
74. Cannon 1993.
75. Cannon 1993.
76. Section 3 of Article XVIII of the Ohio Constitution.
77. Article XVIII of the Ohio Constitution. The article was created by constitutional amendment in 1912.
78. The City of Niles, Ohio, became the first city in the fiscal emergency program, followed by the City of Cleveland. From 1979 to November 1, 2010, the Financial Planning and Supervision Commission aided 59 fiscally distressed municipalities. For the six conditions, see Chapter 118 of the Ohio Revised Code.
79. Chapter 118 of the Ohio Revised Code. From the amendment of the law to November 1, 2010, 22 local governments were in the fiscal watch program.
80. Beckett-Camarata 2004; Coe 2007.
81. Coe 2008.
82. Chapter 118 of the Ohio Revised Code.
83. Since the inception of Ohio's fiscal watch program in 1996 to November 2010, of 22 local governments in the fiscal watch program, 12 were removed from fiscal watch status; the condition of 5 deteriorated, and they entered the fiscal emergency program (http://www.auditor.state.oh.us). Twelve municipalities were assisted and graduated from the program with fiscal health and an improved accounting and reporting system.
84. Auditor of State, accurate as of November 1, 2010. Calculated based on 35 local entities whose fiscal emergency status has been terminated.
85. Taylor 2009.

86. From 1979 to November 2010, 11 of 58 local units that had been in the fiscal emergency program were put in the program by the Auditor of State. From 1990 to November 2010, 4 of 40 local units that had been in the fiscal emergency program were put in the program by the Auditor of State (http://www.auditor.state.oh.us).
87. Grants were excluded because of problems in modeling the endogenous determination of grants among national, state, and local governments.
88. The "fisc" is the combination of a government's fiscal activity and includes revenues, expenditures, and debts.
89. Decentralizing expenditure and borrowing power will need to be sequenced with decentralizing revenue flexibility. Subnational fiscal and debt sustainability is not separable from the intergovernmental fiscal system.

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WITH DECENTRALIZATION AND URBANIZATION, THE DEBTS of state and local governments and of quasi-public agencies have grown in importance. Rapid urbanization in developing countries requires large-scale infrastructure financing to help absorb influxes of rural populations. Borrowing enables state and local governments to capture the benefits of major capital investments immediately and to finance infrastructure more equitably across multiple generations of service users.

With debt comes the risk of insolvency. Subnational debt crises have reoccurred in both developed and developing countries. Restructuring debt and ensuring its sustainability confront moral hazard and fiscal incentives in a multilevel government system; individual subnational governments might free-ride common resources, and public officials at all levels might shift the cost of excessive borrowing to future generations.

This book brings together the reform experiences of emerging economies and developed countries. Written by leading practitioners and experts in public finance in the context of multilevel government systems, the book examines the interaction of markets, regulators, subnational borrowers, creditors, national governments, taxpayers, ex-ante rules, and ex-post insolvency systems in the quest for subnational fiscal discipline.

Such a quest is intertwined with a country's historical, political, and economic context. The formal legal framework interacts with political reality to influence the dynamics of and incentives for reform. Often, the resolution of a subnational debt crisis unfolds in the context of macroeconomic stabilization and structural reforms.

The book includes reforms that have not been covered by previous literature, such as those of China, Colombia, France, Hungary, Mexico, and South Africa. The book also presents a comprehensive review of how the United States developed its debt market for state and local governments through a series of reforms that are path dependent, including the reforms and lessons learned following state defaults in the 1840s and the debates that shaped the enactment of Chapter 9 of the Bankruptcy Code in 1937.

Looking forward, pressures on subnational finance are likely to continue—from the fragility of global recovery, the potentially higher cost of capital, refinancing risks, and sovereign risks. This book is essential reading for anyone wanting to know the challenges and reform options in debt restructuring, insolvency frameworks, and public debt market development.

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