Chapter 1

Introduction

The decentralization[1] of governments throughout the world has brought new prerogatives and responsibilities to subnational governments as service providers to their local constituents. Part of a larger move toward greater democratization of government, reliance on markets, private provision of many activities formerly carried out by governments,[2] and globalization of commerce and finance, decentralization also has encompassed a desire to use private capital markets as allocators of credit.

In developing countries the twin tasks of building more dispersed and democratic governments and opening economies to freer markets and greater private ownership have been attempted in tandem—and have proved a difficult undertaking. A reduction in barriers to the movement of capital and goods has been a nearly universal objective.[3] However, implementation of the required reforms has meant tough competition for domestic industries and increasing constraints on the fiscal and monetary policies of national governments. In the face of economic slowdowns and unstable financial markets, many emerging and developing economies have found privatization and the opening up of their economies to be painful and unpopular. The steep price and uncertain benefits of joining global markets have their critics.[4]

Subnational governments, for their part, are being required to do more things, to do them more efficiently, and to be more self-reliant in raising resources.[5] At the same time devolution and hard-pressed budgets have constrained the ability of central governments to provide for the needs of subnational governments. After years of neglect and with expectations rising, the needs for infrastructure are particularly daunting. The enormous funding requirements cannot be met either practically or equitably without long-term investment. International lending and grant-giving institutions, another traditional source of funds, are also limited in their resources and restricted by rules and customary practice to dealing only through sovereign governments.

Nevertheless, the increased need of subnational governments to mobilize private capital to meet their infrastructure requirements is seen as a positive development in prompting the movement toward greater democratization and decentralization. The day-to-day scrutiny of government operations by credit markets helps to reinforce transparency and encourage efficiency and prudence. However, the markets' rewards are not without risks. Efficient functioning of markets requires rules of procedure for both buyers and sellers and an overarching societal agreement on what is for sale and what is not.

Realizing the Promise of Access to Financial Markets

This book examines the experience of subnational governments in accessing the credit marketplace, seeking lessons about how to realize the promises of credit market access while avoiding the pitfalls. The focus is on countries that are either "developing," in the sense that they are attempting to attain more modern and productive economies, or "transitioning," in the sense that they are moving from a highly centralized and large government sector to a more decentralized and market-based one.[6] Countries often have characteristics of both groups. The commonality is that they are relatively poor in the material sense, have a large central government sector, and have underdeveloped financial markets.

Countries differ, however, in the role that subnational governments have in financial markets and in the nature of their financial markets. Whatever the goals of greater autonomy and capacity at the subnational level, subnational governments vary greatly in political power and decisionmaking authority, in part reflecting differences among unitary states, hierarchical federal states, and governance systems that recognize separate spheres for each level. These differences are embedded in constitutions and legal systems that condition the degree to which subnational governments are free to act and to control the resources with which to act.

Some systems have been devolved at least on paper for many years (as in several Latin America countries), while others are starting from scratch (such as the transitioning countries of Eastern and Central Europe and several Asian counties). Institutional structure and history are important: many of the harsher lessons about balancing subnational debt finance[7] with national macroeconomic stability have to do with the misadventures of poorly designed governmental systems and long-standing problems of fiscal mismatches, political corruption, and mismanagement.

The nature of credit markets also varies. Few developing countries have active securities markets. Where the markets do exist, subnational governments have rarely been participants. Significant domestic markets for subnational debt have begun to emerge in some countries, but the passage has been neither easy nor swift. In a few areas, such as South America, some subnational governments have been active borrowers, but results have been uneven. In most other parts of the world, such as South and Southeast Asia, development at the subnational level has been slower. In the transitioning countries of Eastern and Central Europe, which have had substantial government restructuring and credit market development, subnational borrowing from private sources has risen slowly.[8]

Several larger and better-known subnational governments have borrowed in foreign markets, an avenue that appeared promising until the twin crises of foreign currency collapse and global economic slowdown that occurred in the late 1990s. While restoration of world capital markets will help governments meet their financing needs, the more immediate issue for the vast majority of subnational governments in developing countries is how to raise funds in domestic capital markets.

Presenting Governments with Market-Based Alternatives

Several vantage points are possible when surveying subnational government access to financial markets. One is that of the "macro-level" policymaker determining how best to fit a municipal borrowing component into domestic and international credit markets, given a host of other policy constraints and objectives. A second is that of the prospective subnational government borrower, intent on achieving as much flexibility as possible in financing decisions and on securing capital on the best possible terms. A third is that of the lender or investor who needs information to assess relative rewards and risks (including remedies in case of trouble) and assurances that the rules of the game will not be violated or changed arbitrarily.

While these three views are not always consistent, the ultimate objective is the same: to improve subnational governments' access to private credit markets in ways that are consistent with the overall fiscal health of government and the viability of the domestic financial markets. However attractive the rhetoric, achieving the objective requires making choices and taking risks.[9] Without being prescriptive about a best approach in all cases, this book starts from the premise that subnational control and decisionmaking are desirable outcomes that should be cultivated and encouraged. While acknowledging the need for rules, the book also argues for maximizing competition among private sector financial options at the subnational government level, where possible and prudent. This reflects a belief that presenting governments with market-based alternatives is invariably better than any single "my way or no way" of doing things. The book further calls for a liberal view of the risks that subnational governments should be allowed to run; this liberal view entails a presumption that these governments assume the risks at their own peril but that they do so in capital markets that are fair and reasonably efficient.[10]

The terms *credit market* and *capital market* are used broadly. In many emerging economies the banking system is the leading provider of credit—and the banking system too is likely to be undergoing transformation. The reliance on banks may be either a substitute for or a precursor to a functioning domestic securities market in subnational government obligations.

Where possible, a securities market should be seen as a desirable means of obtaining long-term capital. Appealing to the rapidly growing numbers of nonbank institutional investors, securities markets were developing rapidly until repeated crises struck emerging bond and equities markets in the late 1990s. Activities in these markets slowed abruptly in reaction to unsettled conditions in global financial markets, a series of currency crises, and the general slowing of the world economy. The arguments in favor of securities markets do not deny the critical importance of the banking system as the bulwark of the financial system. To develop and thrive, markets for longer term debt require strong banking systems on which they can depend for a reliable system of payments. In many countries, the practical outcome may be to promote competition among institutions that lend to subnational governments or even to find ways to reproduce the benefits of competition. Immature capital markets should not deter efforts to create structures that can reproduce such benefits.

Setting Out the Analytical Framework

Thus the analytical framework for this study rests on the principle that a subnational government securities market is desirable and that subnational borrowing will be dictated largely by the operation of the market, working within a framework of rules necessary to keep it a free and efficient allocator among competing uses. Many conditions need to be met, but four are key:

- Subnational governments borrow of their own volition and rely on their own resources for security and repayment of debt.
- Capital markets are free of excessive restrictions—with an arm's-length relationship between government and markets and banks—and allocate resources on the basis of risk and reward.
- The market has full access to the information required to assess the financial condition of borrowers and to determine risk and reward.
- Subnational borrowing is subject to appropriate oversight by the central government before it is made available. The central government plays a supportive role, intervening only when well-established rules of borrowing are flouted or subnational government mismanagement threatens fiscal crisis.

The ability—and desire—of governments and financial markets to achieve these conditions depend on several related policy and technical issues. A variety of government structures, schemes of devolution, and problems of macroeconomic stability influence decisions about the nature and feasibility of subnational government borrowing (chapter 2), as do a country's legal systems and financial market structures (chapter 3). Thus it is important to understand the political, economic, and legal environments in which subnational government borrowing occurs.

In analyzing options and possibilities for markets in subnational obligations, some key questions need to be asked. On the borrowers' side, important issues are credit capacity, borrowing powers, and regulation within the government sector (chapters 4–7). What types of debt security are available? What debt instruments are to be used? What types of subsovereign governments are good candidates to borrow? How is subnational debt to be authorized? What limitations should be placed on borrowing? What is the role of monitoring and oversight? What are the remedies in case of fiscal problems?

On the investors' side, regulation, investor needs, and the operation of financial markets are important concerns (chapters 8 to 12). What is the financial market structure? Who are the potential investors, and what are their investment objectives and constraints? What is the regulatory framework of the marketplace? What is the role of disclosure, and how is it accomplished? What is the role of credit analysis and credit ratings? How can the private sector mitigate risks? How should credit assistance be provided to comport with the market?

These questions represent economists' familiar separation between the demand for loanable funds by the subnational government sector and the supply of funds by private suppliers of credit. This separation is conceptually useful, but in practice matters are more complicated. The links between subnational governments and credit markets, even in countries with only a nascent financial sector, are diffuse and complex. Few actors are interested in only one financial relationship, such as borrowing, and the relationships are often more than financial. Nevertheless, the point of departure is that subnational governments are increasingly important economic actors, and the stage on which decisions are made is increasingly that of the market. All these issues are explored in the first part of the book.

The second part is a series of case studies that discuss recent experiences in 18 developing and transitional countries. The case studies range from general reviews of subnational credit access on a countrywide basis to more detailed discussions of debt transactions and lending. The case studies present a rich variety of experiences, good and bad, with subnational government borrowing and offer lessons about which approaches have been successful and why. They also illustrate experiences that have been disappointing and attempt to explain why.

Notes

1. The terms *devolution, decentralization,* and *deconcentration* are frequently used synonymously to describe the process of giving more decisionmaking power to subnational governments. In practice, this process varies greatly, as does the degree to which fiscal powers are devolved. In many cases, decentralization has meant a dispersal of spending and taxing powers that remain tightly controlled by the central government. In other cases, localities have been given a full range of taxing and spending powers, including the power to borrow. The terms are used interchangeably unless otherwise noted.

2. The conflict between government control and the freeing of markets was a common theme throughout the twentieth century and is treated on a global scale in Yergin and Stanislaw (1999).

3. This is the often-cited "Washington Consensus" for liberalizing trade and international financial flows. It has been actively promoted by the International Monetary Fund, the World Bank, the World Trade Organization, and the U.S. Treasury.

4. See, among others, Stiglitz (2002).

5. This book often uses the terms *local, municipal, subnational,* and *subsovereign* interchangeably, unless dealing in a specific context. The terms

can also encompass states, regions, provinces, and other subnational governments, depending on context.

6. The terms *developing, emerging,* and *transitioning* (*transitioning* is typically applied to Eastern and Central European states that are changing from communist to democratic regimes) are used interchangeably.

7. *Debt, loans*, and *bonds* are used interchangeably to refer to subnational government debt finance, depending on context.

8. Noel (2000) notes that subnational debt markets have grown rapidly in Argentina and Brazil (representing as much as 5 percent of GDP), but they remain "embryonic" in most emerging and transitioning economies, including the relatively advanced states of Central Europe (p. 1). He foresees a clash between the rapidly rising needs for infrastructure finance and the limited development of the domestic markets.

9. Noel (2000) sees the movement as being from either a nonexistent or a monopoly market for subnational government debt to one of active competition among alternative sources of private capital (from a closed to an open system of financing investment needs). It is a movement filled with risks and tensions among key stakeholders: the national government, private investor institutions, and subnational governments. This is usually a simplification since there are competing interests within the sectors. The private sector has tensions among commercial banks, other financial institutions, and securities markets. The central government may have competing interests among agencies (the treasury and the central bank, for instance) and competition among the local governments themselves, which once were agents for the central government and now are striving to become more independent.

10. A source of continuing concern is that of the moral hazard that local governments present when they enter capital markets with an implied sovereign guarantee that the national government will be compelled to bail them out if things go wrong and they cannot pay their debts as promised. There are a large number of assumptions surrounding the implied existence of such guarantees and quite a bit of history as well. The assumption in this book is that sovereigns as part of the move toward devolution are reluctant to make such guarantees and are inclined to have their local governments face a "hard" budget constraint.