Part V

Policy Guidelines

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Chapter 13

Concluding Observations and Policy Guides

Subnational government borrowing is not an end in itself. Ideally, it should be used to obtain long-term capital for expenditures that provide benefits that stretch into the future. Repaying debts represents the fulfilling of an intergenerational contract obligating those who benefit from improvements to pay their share of costs over time. Subnational governments are the legitimate parties to effectuate the obligation and the agents to see that its terms are fulfilled.

Successfully incurring and paying off debt—raising funds in capital markets, employing the funds in useful improvements, and repaying the debt according to the contract—is an affirmation that the subnational government is capable of planning for the future and fulfilling its obligations. Successful debt transactions are both products of financial prudence and foresight and installments toward financial independence (DeAngelis and Dunn 2002).

That said, the gap between the ideal and the real in subnational government borrowing in private financial markets is great. Subnational governments, as junior and often freshly minted government units, must find ways to enter financial markets that are themselves young and troubled in legal and economic environments that are often in transition.

Credit market access has been approached from various angles: the needs of potential borrowers, the organization and regulation of the securities market, likely investor groups and their regulation, the need for information to analyze credit, and the rating and private insuring of securities. This book examines, in particular, the tools that senior governments and donors might choose in developing markets, looking at forms of credit assistance and methods by which higher level governments monitor and, when necessary, intervene in the affairs of subnational governments.

While it is clear that different structures of government and levels of credit market development affect the particular circumstances of each country, the following observations on policies and practices can serve as a point of departure in appraising a country's willingness and readiness to promote markets for subnational government securities. They also can stimulate debate on existing markets and on how access to them might be improved and new markets for subnational securities might best be engendered.

Security Pledges, Instruments, and Methods of Sale: From What Sources Should Subnational Debt Be Paid, What Forms Should It Take, and How Should It Be Sold?

Determining the appropriate scope and pace of subnational government borrowing and the forms it should take has presented problems for national governments, financial markets, and subnational government borrowers. Over-regulation and encrustations of out-of-date, ill-defined, and conflicting laws have caused problems. Subnational credit access has often been an afterthought, in terms of both fiscal powers and financial market development. Overall, generic laws with broad formulations of policies and simple parameters based on easily obtainable and objective criteria are better than specific procedures that must be followed with respect to borrowing.

Governing laws should make clear the *legal status and remedies* available to investors in subnational government obligations. This is frequently not the case, especially where subnational government obligations once carried explicit or implicit sovereign guarantees. The ultimate security and the enforcement process for creditors should be explicit and easy to call on. *Flexibility is important* in setting the boundaries of prudential behavior. Parties to debt transactions should be able to design security provisions to meet specific needs and circumstances, as well as general requirements. Essential services, for example, can be defined and minimum service levels protected in the case of assets and intergovernmental transfers used for pledges.

In addition to general obligation debt (supported by general revenue), local jurisdictions should be able to offer *limited obligation security* arrangements (revenue bonds) that do not involve a pledge of general revenues. Subnational governments should be able to enter into tariff setting and other covenants for limited obligation debt. If higher level governments retain ratemaking approval, provisions should be made for prior approval of rate adjustments or for some indemnification against default where the subna-

tional government lacks the ability to adjust rates. The issues involved in rate setting and minimum service levels are thorny in low-income countries, but full costs need to be identified and any subsidies made explicit.

Subnational governments should generally be able to *assign revenue*. This includes having the ability to pledge *intercepts of intergovernmental revenue transfers*. However, certain limitations on such pledges make sense. An exception can be made for revenues that are necessary to provide minimum essential services. This could be achieved through a regulation specifying a maximum share of transfers that may be pledged to debt service payments.[1] So long as intergovernmental transfers constitute a large proportion of local revenues, as is usually the case, any prohibition against pledging funds from these sources effectively foreshortens the fiscal planning horizons of subnational governments.

Subnational governments should have the ability to create or to join with others in creating *special service districts* to address service needs related to specific areas or activities. Where government jurisdictions do not correspond with the rational service area, subnational governments should be strongly encouraged to cooperate. Applying the benefit principle, they should have revenue powers that allow them to capture a share of the value created by their activities and investments made within or on behalf of those districts. In both developing and developed countries electorates frequently are more supportive of taxes and charges that are directly related to specific physical improvements and service betterments.

The financial marketplace should be free to decide on the types of instruments and associated payment mechanisms to employ. Unless there are compelling reasons to place restrictions on all borrowers, there is no basis for treating subnational governments differently than other borrowers so long as there is *full disclosure and competitive norms* are met. However, if there is no effective competition in financial markets (including a reasonable basis of shared knowledge by borrowers and lenders), then more oversight is likely to be needed. At a minimum, strict rules are required on *public notice and disclosure of proposed transactions*.

Wherever possible, it is best to introduce competition into financial markets. As a first step, competition can be promoted by requiring subnational governments to use *formal solicitation and bidding procedures* for banking services, underwriters, advisers, investment services, and other professional specialties. Clearly, public and timely reporting on the terms and conditions of loans and bond offerings is a necessary complement to supporting a competitive regime. Even where financial markets are not fully

developed and effective competition is limited, the bidding process and full disclosure of transactions should help prevent monopolistic behavior and encourage entry by private lenders.

Borrowing Power: How Much Can Be Borrowed, and Who Must Approve?

Restrictions on borrowing powers are appropriate in many emerging market economies, where the objective is to balance local self-determination with limited experience and shallow capacity in financial markets. At the same time, the object of political devolution is to link self-determination with fiscal self-sufficiency and local accountability. If financial markets are developing in the right direction, this goal may best be accomplished by using incentives that operate through the market. The issues are ones of sequence and scope: within what boundaries should the market decide on lending, and how should those boundaries change as the market matures?

While the focus of much of this book is on long-term borrowing to meet infrastructure needs, many subnational governments now rely on short-term loans to meet cash cycle needs or to finance budget shortfalls. Such *short-term borrowing*, while a useful tool when responsibly limited to a single fiscal year, has often been the Achilles heel in budgetary discipline. Short-term debt should be used only to meet cash flow shortfalls in anticipation of realistic income streams within the fiscal period. That means that under most non-emergency circumstances, short-term debt should be paid off by the close of the fiscal year.

The corollary, often built into governing law, is that *long-term debt should be limited to capital investment in property, plant, and equipment.* It should not be used to finance operating deficits except as part of a financial emergency recovery plan as defined by statute and regulation. Effective enforcement of such provisions on the appropriate use of debt requires regular reporting of borrowing and the purposes for which it is undertaken. The reporting should be based on a chart of accounts that is clear and analytically meaningful.

Limitations on outstanding debt constitute a basic form of restriction for debt that is secured by general revenues. The restriction should be related to the tax base (where the subnational government is largely self-reliant and has control over its revenue resources) or some measure of recurring revenues (which is more typically the case where localities rely on intergovernmental payments). However, limitations on total debt are only a rough gauge of permissible debt burden. Where possible, the limitation should be

expressed in terms of *annual or maximum debt service*. For example, total debt service (principal and interest) on general obligation long-term debt should be limited to a maximum percentage of projected recurring annual revenues. For self-supporting debt issued to finance revenue-generating projects, however, the market should determine acceptable ratios of debt service coverage. Such projects will vary according to the technical and economic aspects of the improvement being financed and the security being pledged. Definitions matter, and the terms used in limitations need to be precisely defined.

Guarantees constitute a problem in the application of debt limitations, since the extent of guarantees is usually a missing link in debt limitation calculations. There are few quantitative restrictions on the use of guarantees. The common solution is to value against the debt limit that portion of guarantees that appears likely to be called on within a given fiscal period and to treat the remainder as contingent debt that is in effect self-supporting and not counted against the debt limit. Again, the problem is less the guarantees themselves than the reporting of the guarantees.

Approval of borrowing by a jurisdiction's legislative body is sufficient in most cases to obligate the unit, so long as the debt outstanding after the proposed borrowing falls within pre-stated legal parameters. Some countries have provisions for citizen referendum, although this is not customary in most countries and can be expensive and disruptive. Some countries require that the local budget be approved by a central government agency and that anticipated borrowings be included in the budget. Such routine budgetary review by national authorities, so long as it observes broad and general parameters, need not be overly intrusive and can help in the timely reporting of information and in the formation of macroeconomic policy. However, requiring specific prior approval of transactions by senior levels of government diminishes local flexibility and responsibility and opens the door to delay and political manipulation. Waivers of limitations in unusual cases by cognizant state or national authorities may help flexibility.

Financial Market Regulation and Disclosure: What Should the Market Look Like, and How Will It Perform?

In most developing and transitioning countries banks dominate the financial system, but with a nascent securities market beginning to broaden the financing landscape. For the most part, financial markets still do not meet the long-term credit needs of local governments. That gap is filled by na-

tional or regional government-administered on-lending programs funded by multinational donors. The observations here assume a desire to develop the securities markets as an effective alternative to a near-exclusive reliance on the banking sector or a specialized lending institution.

The *regulatory framework* for banking and securities markets should apply to subnational government borrowers just as it does to other borrowers. That framework seeks to foster the competitive norms of market efficiency and development while preserving the integrity of the payment system and protecting investors. Generally, subnational governments should enter financial markets on an equal footing with private firms, while recognizing the distinctions that flow from their taxing and governing powers. Where banking and financial regulations favor the national government, consideration could be given to according the same benefits to subnational governments, along with appropriate limitations.

A *secondary market for securities* is important to investor liquidity, but establishing such markets is inherently difficult where financial markets are small. Formal listing of subnational securities on exchanges should be required only where the potential size of secondary activity justifies the time and expense involved. Furthermore, the practical limitations on attracting long-term investments in local currency need to be considered. Alternatives might include intermediaries capable of borrowing on behalf of subnational governments on domestic and international markets and a liquidity facility to back up instruments that provide built-in liquidity, such as put-option bonds.

In some cases a secondary market for subnational debt can be developed as part of the over-the-counter markets that operate among banks and security dealers. These are likely to be more efficient for smaller issuers, whose bonds are traded infrequently. Investor protection needs to be balanced with economical access for smaller issuers, which should be a fundamental tenet of both registration and disclosure requirements.

A key concern in securities market regulation is proper disclosure. Like other securities, subsovereign securities should be subject to *disclosure standards* that require both information at the time of the initial offering and regular reporting to investors subsequently. The standards should focus on the process and generic needs. Some of the information required of governments is different from that required of private firms, and disclosure requirements should reflect that. The actual data needs for meeting such standards may best be left to self-regulatory bodies in the market and to participants in individual transactions.

Subnational government financial information needs to be reported in clear, consistent formats and promptly after the close of the fiscal period. For debt-monitoring purposes reporting on a cash or modified accrual basis is especially useful, as are cash-flow statements. Charts of accounts should reflect the needs of debt analysis, terms should be clearly defined, and users should be trained in their application. Audits should be independent, recurring, and punctual. Where governments are too small to afford independent audits, borrowing is most likely to be successful thorough a market intermediary or trustee relationships that allow for funds to be sequestered to ensure payment.

A *central repository* of financial information on government borrowers is a useful tool in promoting efficient disclosure. The repository should have current data on debt outstanding and information on security pledges and liens against real and personal property if that information is not recorded elsewhere. Markets will not thrive without information, and making information broadly available is good public policy.

Credit Analysis, Credit Ratings, and Bond Insurance: How Can Risk be Measured and Mitigated?

Credit analysis is a product of the credit market's need to assess risk. A financial market becomes viable only when there is a variety of competing investors and, similarly, investments with different risk and reward characteristics. Where there are large numbers of "passive" investors in securities that are widely held and transactions are diverse and numerous, these investors generally rely on the opinions of specialists. This need is often reinforced by various prudential requirements that are framed to ensure the investment quality of institutional portfolios.

Credit ratings, typically shorthand expressions of relative ranking among credits, are the leading form of institutionalized credit analysis. They assist in developing an active securities market by pooling skills to develop opinions. Credit ratings play an important role. They focus on credit risk (risk of payment delay or default), which then is used to help judge overall risk and reward. The use of ratings has grown steadily as markets have expanded, and they promise to play an increasing role in the regulation of banks and institutional investors.

Credit ratings have the *positive side benefit* of ranking governments on their perceived ability and willingness to pay their debts and avoid financial difficulties. The ratings are easily understood—hence their popular ap-

peal—and contribute to the essential task of improving finances by providing an incentive to upgrade one's rating. However, credit ratings tend to centralize and dominate credit analysis, and the precise basis for the ratings is not always clear since their calculation is based on proprietary criteria. Credibility requires accuracy, a reputation for objectivity, and freedom from influence. The demand for ratings should derive from the market itself (even if part of that demand is a function of regulatory requirements on institutional investors), with competition among ratings companies. In domestic financial markets, it is not a good idea to have "official rating agencies" or to have the government set standards for ratings. Foreign markets are likely to require internationally accepted ratings.

Private sector *bond insurance* and other forms of *credit enhancement* are important in developed financial markets and may have application to subsovereign credits. The major bond insurance companies were seeking opportunities in emerging market economies during the 1980s and 1990s until the financial crises of the late 1990s dulled their appetites. With the possibility for diversification of holdings within countries limited and confidence in many currencies eroded, commercial bond insurance will be slow to take hold. Furthermore, the private bond insurance industry is highly dependent on credit ratings of their portfolios. The volatility and generally lower-rung ratings given to emerging market credits create heavy capital requirements and make it difficult for companies to price their products competitively. However, domestic credit enhancement programs that have sufficient capital, are market-oriented, and use insurance principles in determining appropriate charges may hasten development. Domestic bond insurance in the Philippines is a promising "home-grown" alternative that can assist local borrowers (see Philippines case study, chapter 26).

Financial Oversight, Monitoring, and Intervention: How Should the Central Authorities Monitor Subnational Financial Conditions and React to Financial Emergencies?

Even in countries where the credit operations of subnational governments are largely autonomous and subject to general rules, positive action by higher-level government has a place. This is especially so in requiring the collection of timely, complete, and pertinent financial information. Without comparable and consistent information on borrowers, financial markets operate in a cloud of uncertainty, with personal and political relationships dominating decisions rather than objectively measured conditions and results.

A *regular and universal reporting system for subnational governments*, founded on an accounting system relevant to the information needs of investors and prepared by properly trained officials, is a prerequisite for market development. Most important is the ability to report direct and contingent debts outstanding, current debt service requirements, and cash funds available to meet those demands as well as baseline operating expenses. While the ability to support other measures of performance and conditions is highly desirable, reliable basic data on meeting pending debt obligations and regular operating needs are indispensable to market development.

Gathered data should be made public. In countries with active financial markets for subnational obligations, disclosures may suffice since self-interested participants conduct the reviews and analysis. However, in most cases these data should also be *subject to review* by the appropriate national-level agencies to ensure that the numbers are right and to monitor the conditions of governments. Such monitoring need not be intrusive, but it can provide a warning if subnational governments are violating the rules or showing signs of financial weakness.

Intervention by higher levels of government in a subnational government financial emergency should be comprehensive and thought out in advance. Interests need to be balanced to avoid moral hazard. The responsible parties should bear the risk, sharing the pain of mistakes and bad fortune with those that would have enjoyed the fruits of investments. Intervention measures should provide for *creditor rights, remedies, and workouts*, as well as for the financial recovery or dissolution of the debtor unit. There should be added flexibility in terms of making specific pledges of security and remedies a matter of contract. However, it is best to have in place a statutory framework to define rights, essential services, and the procedure for recomposition of debt. Interventions should be rare, and not be used as a backdoor means for the higher-level government to bail out subnational governments and their creditors.

Credit Assistance and Financial Interventions: How Can Credit Assistance Encourage the Development of Private Capital Markets?

For most emerging market economies subnational government access to private financial markets is an achievable goal. However, it is not achievable overnight and may not be achievable for all subnational governments. Meanwhile, many emerging and transitioning countries will continue to

depend on various forms of assistance to help satisfy the capital financing needs of subsovereign governments. For the most part, such aid will either be sanctioned or administered by central government agencies and, in all likelihood, will be funded by multilateral and bilateral assistance agencies. These sources of funds are not adequate to meet all needs, but the prospect of grants and loans on concessionary terms makes them attractive. The longer-term policy objective, of course, is to make subnational government borrowers self-reliant and the markets in which they borrow adequate suppliers of long-term capital. How best to move in that direction?

Credit assistance should be provided only to the level needed to permit a subnational government to access private credit markets. This requires *integration of grants* that might be given with the loans. Subnational governments, to the extent possible, should face the costs and demands of private credit markets at the margin in meeting their financing needs. Borrowing is not appropriate in many settings. Subnational governments that are too poor and too small to borrow in the private market should not be encouraged to borrow until their underlying financial situation makes that feasible.

Direct lending, interest subsidies, guarantees, insurance, and other financial assistance should be designed to provide subnational governments with *incentives to access the market* on their own. Such assistance should recognize *differences in creditworthiness* and reflect those differences in the interest rate and loan amount. Debt contracts, even if given on preferential terms, need to be written to commercial standards and enforced. The goal of exposing subnational government borrowers to the discipline of private markets needs to be encouraged at every step.

Financial intermediaries that pool smaller loans into larger offerings, as in *bond banks,* can provide economies of scale and give investors opportunities for greater depth and liquidity in the secondary market. *Bond banks and loan pools* can be sponsored by either the public sector or the private sector but should function as financial institutions and be subject to credit market discipline.

Other devices work through private financial markets and encourage their development. These include *government-sponsored co-lending programs, credit enhancements, and liquidity support facilities.* Their success will depend on private sector investors gaining confidence in the domestic market as a place to put long-term capital and in subnational government issues and loans as prudent and profitable investments. Donor lending programs need to promote innovations in assistance that advance the enlistment of private capital market sources. Skillful use of enhancements that leverage the

amount of donor aid to encourage private market participation needs to be encouraged further.

Note

1. This is akin to a minimum coverage requirement often found in limited obligation bonds.