Chapter 28

Eastern and Central Europe
Czech Republic

Unfettered local borrowing powers prove illusory without credible investor security and effective market regulation.

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Lessons

The case of the Czech Republic illustrates the difficulties of balancing liberal subnational borrowing provisions with the practical realities of developing sufficient regulation and oversight of local finances—regulation and oversight needed to maintain macroeconomic stability and a functioning subnational credit market.

The Czech government has not carried decentralization far. One problem has to do with size and wealth. While a few large cities have substantial own-source revenues, most local governments are small and heavily dependent on the central government. Changes under way should lead to greater decentralization.

The Czech Constitution declares municipal borrowing a legally protected right, but having a right to access credit and having an effective framework for doing so are two different things. An

inability to pledge future revenues, which the law does not recognize as a source of collateral, has constrained local credit. Despite such problems with debt security, local borrowing grew rapidly in the 1990s. Some small municipalities ran up unsupportable debt and may be insolvent. Others borrowed heavily for tourism infrastructure and in expectation of the revenue it would bring. A few large municipalities issued bonds to fund substantial capital spending.

The early rapid increase in bond debt ran counter to the central government's fiscal adjustment goals, and the government imposed a temporary ban on new bond issues in the late 1990s. The ban was rescinded by 2000 as local debt leveled off. However, continuing shortcomings in public finances and the regulatory framework leave a potentially risky fiscal situation, which has dimmed creditors' enthusiasm. One reason creditors are reluctant to lend to local governments is that the existing bankruptcy law does not apply to subnational units.

Policy and regulatory shortcomings have softened budget constraints and introduced moral hazard. These shortcomings include a lack of transparency in local finances because of accounting practices, the absence of an entity to monitor local finances, an unstable and idiosyncratic intergovernmental transfer system, and the limited restrictions on local borrowing. Lack of transparency makes it difficult to analyze the financial situation of local governments and may explain the rapid increase in local debt. There is little legal basis for central control, which is exerted indirectly.

A combination of pro-market mechanisms and regulatory controls would foster a sustainable subnational credit market, and several reforms are suggested. These include restricting loans to capital expenditures, clarifying security provisions, imposing limits on local government debt, introducing prudential requirements on lending to local governments, and instituting bankruptcy provisions and disclosure provisions. Also recommended is establishing a monitoring agency and the use of credit ratings to encourage fiscal prudence.

The Czech Republic began its transition to democracy and a market economy in 1989 from what many considered the most favorable position among the prominent transitioning economies now vying for membership in the European Union (EU) . While not without difficulties and disappointments, the transition has been largely successful, revealing a country with a wealthy and diverse economy, a strong industrial base, and a skilled labor force.

In 2001 unemployment fell for the first time since the transition began, to 8.1 percent. Inflation remained fairly low at less than 4 percent. A high level of foreign direct investment (among the highest in the region) has increased productivity and competitiveness, facilitating the restructuring of industry. These positive forces notwithstanding, the Czech Republic underwent a recession in 1997–99 that eased only in 2001, with strong domestic demand and investment-driven real growth of 3.6 percent. However, the current account balance worsened in 2001 for the third consecutive year, showing a deficit of 4.7 percent of GDP.

The Czech Republic has had its share of difficulties in entering the global economy. Immediately after its transition to democracy and free markets, the country latched onto fixed exchange rates, believed to be needed to encourage foreign investment. A surge of investment and an immature financial system led to a sharp rise in inflation. This was soon countered by high interest rates to defend the currency. Rather than simply slowing inflation, however, the tight monetary policy led to severe deflationary pressures and, coupled with imprudent lending practices, resulted in many business failures.[1]

The transition to a market economy is not complete in the Czech Republic. Important structural deficiencies remain, including a need to carry out judicial reforms that already have been enacted and to curb corruption and citizens' resulting distrust in government and in the process of privatization. Crucially, events relating to the three-year recession have called into question the effectiveness of bankruptcy laws and the quality of corporate governance and transparency. In the early 1990s, when privatizations surged, the structure of the privatizations allowed the state-controlled banking sector to take indirect control of many state enterprises. This situation encouraged poor lending decisions by banks. As the recession set in, the banks' fragile loan portfolios were exposed, revealing questionable corporate practices that fueled citizens' distrust. The government responded with tighter regulation and supervision of banks. A large state bailout of banks followed, contributing to a deterioration in public finances. This deterioration could adversely affect government debt and already is reflected in an unspectacular (though stable) national credit rating.

Subnational Government and Fiscal Management

The overall level of subnational debt needs to be seen as the product of local government decisions, which in turn reflect the structure of inter-governmental fiscal relations in the country and the effectiveness of the overall fiscal management and budgeting.

Intergovernmental Relations

The autonomy of local governments in the Czech Republic is still evolving. Immediately after the communist regime, and the breakup with the Slovak Federal Republic in 1993, the country administration was structured into two levels of government: the central government and 6,191 municipalities. The government structure was highly centralized, and municipalities had no capacity to raise revenue other than collecting local fees and charges. In 1994–2000 local expenditures made up a little more than 20 percent of the national consolidated budget, comparing unfavorably with some other transitioning economies such as Poland and Hungary. However, tax amendments in recent years have reduced municipal reliance on central transfers, and additional planned tax changes will increase local fiscal autonomy. Prague alone accounted for almost 17 percent of municipal expenditure in 2000, highlighting its importance in the national economy.

The structure of local government is undergoing reform. The 73 state district offices, which had little revenue raising capacity and only limited responsibilities under centralization, are being replaced with 14 newly created regional governments. With this change comes the prospect of significant devolution of revenues and responsibilities. Own-source revenues have been fairly small, with the central government determining major tax rates and bases and collecting most revenues. Under new legislation, however, a portion of state tax revenues is to be shared among the 14 regions as control of regional transport and other infrastructure is passed to them starting in 2001–2002. Beginning in 2002–2003 the plan has been to give regional governments their own tax revenues and perhaps introduce new municipal taxes.

Local governments already have some service responsibilities, including primary and secondary education, urban development (housing with water and sewerage infrastructure), some social services, and control of small state institutions (for example, agricultural education institutions). The gradual decentralization has not been burdensome to local governments because revenues have been increased to match the expanded responsibilities, sustaining sound local budgets.

Public Sector Debt

During the 1990s public debt outstanding in the Czech Republic averaged around 13.5 percent of GDP, with local government debt—a relatively new phenomenon in the country—increasing from 0.3 percent of GDP in 1993 to 2.2 percent in 1999 (table 28.1). Thus the Czech Republic appears to do well with respect to the Maastricht general criterion for fiscal discipline.[2] Nonetheless, a more conclusive assessment of both local financial sustainability and macroeconomic stability would require also taking into account all forms of contingent liabilities in the Czech Republic, at each level of government.[3]

Table 28.1. Public Debt Outstanding, Czech Republic, 1993–99

Debt item	1993	1994	1995	1996	1997	1998	1999
				(billions of koruny)			
Municipal	**3.4**	**14.3**	**20.3**	**28.3**	**34.4**	**39.0**	**40.0**
Loans	2.5	4.9	8.7	11.6	13.5	18.0	17.6
Bonds	0	7.6	8.5	11.9	13.2	11.9	10.9
Others	0.9	1.8	3.1	4.8	7.7	9.1	11 5
State	**158.9**	**157.3.**	**154.4**	**155.2**	**173.1**	**194.7**	**228.4**
				(percentage of GDP)			
Municipal	**0.3**	**1.2**	**1.5**	**1.8**	**2.1**	**2.2**	**2.2**
Loans	0.2	0.4	0.6	0.7	0.8	1.0	1.0
Bonds	0	0.6	0.6	0.8	0.8	0.7	0.6
Others	0.1	0.2	0.2	0.3	0.5	0.5	0.6
State	**15.9**	**13.3**	**11.2**	**9.9**	**10.4**	**10.8**	**12.4**
Total	**16.2**	**14.5**	**12.6**	**11.7**	**12.4**	**13.0**	**14.6**
				(percentage of state debt)			
Municipal	**2.1**	**9.1**	**13.1**	**18.2**	**19.9**	**20**	**17.5**
Loans	1.6	3.1	5.6	7.5	7.8	9.2	7.7
Bonds	0	4.8	5.5	7.7	7.6	6.1	4.8
Others	0.6	1.1	2.0	3.1	4.4	4.7	5.0
				(percentage of municipal revenue)			
Municipal	**4.5**	**15.4**	**19.1**	**24.8**	**27.8**	**28.3**	**23.6**
Loans	3.3	5.3	8.2	10.2	10.9	13	10.4
Bonds	0	8.2	.8.0	10.4	10.7	8.6	6.4
Others	1.2	1.9 .	2.9	4.2	6.2	6.6	6.8
				(percentage of municipal tax revenue)			
Municipal	**11.4**	**31.6**	**34.8**	**45.1**	**52.3**	**54.1**	**52.9**
Loans	8.4	10.8	14.9	18.5	20.5	25.0	23.3
Bonds	0	16.8	14.6	19.0	20.1	16.5	14.4
Others	3.0	4.0	5.3	7.6	1l .7	12:06	15.2

Sources: Czech Republic Ministry of Finance; World Bank staff estimates.

As in many other unitary countries, in the Czech Republic local governments have had only limited discretion in financing their expenditure. Since local governments cannot print money and have very limited tax autonomy, their most important option for financing local fiscal imbalances has been to borrow. Commercial sources of borrowing include loans and credit from banks and other sources, including bond issues. Noncommercial sources include interest-free or subsidized loans from the state, mainly under programs operated by the Ministry of Finance and the State Environmental Fund. In addition, municipalities have often provided guarantees and assumed contingent liabilities that may expand their effective financial exposure. Although this exposure does not appear yet to have been excessive, it represents a potential fiscal risk to macroeconomic stability that the central government should monitor. Whether local government debt becomes a macroeconomic threat depends on how the economic system perceives the debt and whether indebted local governments are explicitly or implicitly backed by the central government.

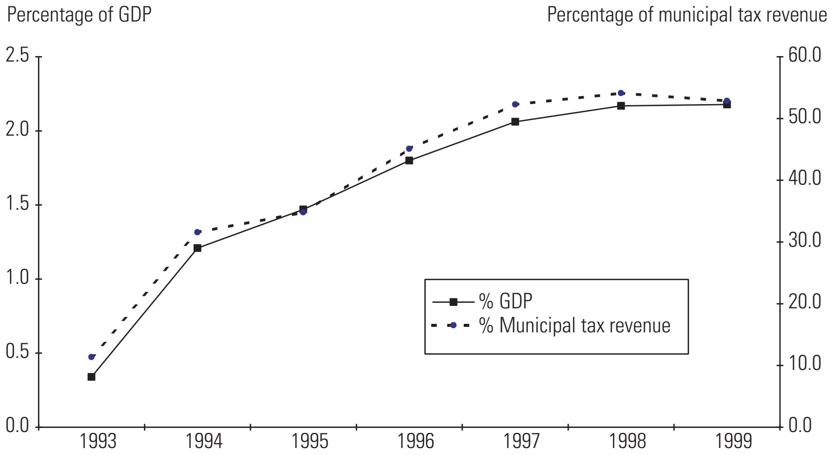
Local Fiscal Imbalances and Debt Accumulation

In the Czech Republic municipalities, as self-governing entities, are the only local governments that can borrow. District offices do not have the power to assume contractual financial obligations of their own because they are merely administrative bodies of state territorial administration. In the future, as the new regions substitute for the old districts, it is likely that these intermediate levels of government also will acquire the right to borrow.

Growth of Municipal Debt

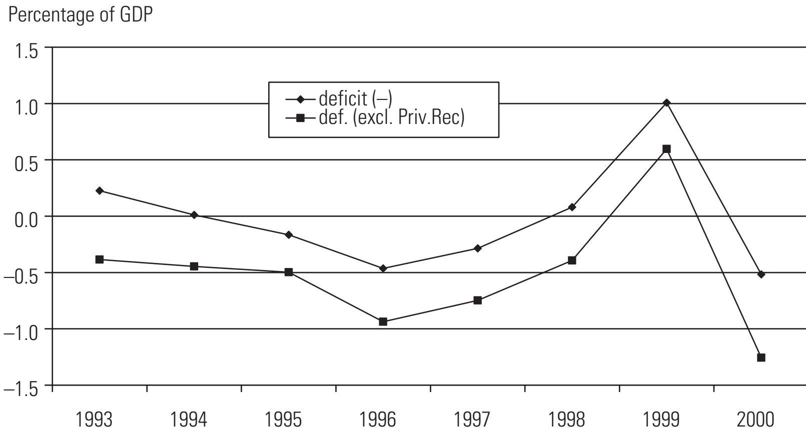
The outstanding debt of Czech municipalities grew steadily in 1993–99, rising from 11 percent of municipal tax revenue to 53 percent. In 1999 this debt was equal to 2.2 percent of GDP and almost 20 percent of the state debt (figures 28.1 and 28.2).[4]

Although municipal debt still may be considered too small to be an immediate threat to macroeconomic stability, its rapid growth in 1993–99 (by tenfold) is worrisome. The stabilization of municipal debt outstanding relative to GDP in 1999 (and even the slight drop relative to municipal tax revenue) appears to have been a result of significant sales of financial assets during that year (including stockholder rights in shares of energy distribution companies). These sales enabled municipalities to meet their entire financial needs for the year, including some debt amortization. More worri-



Source: Ministry of Finance.

Figure 28.1. Municipal Debt Outstanding, Czech Republic 1993–99



Source: Ministry of Finance.

Figure 28.2. Local Fiscal Deficits, Czech Republic 1993–2000

some, however, is that the reasons that municipal debt outstanding grew so rapidly during the decade are not entirely transparent. There is no evident correspondence between the imbalances in municipalities' fiscal accounting flows (reflected in figure 28.2) and their accumulation of debt (see fig-

ure 28.1). While fiscal flow statistics show that municipalities' fiscal position was reasonably stable during the 1990s (that is, with small deficits alternating with small surpluses), aggregate municipal debt outstanding accumulated quite rapidly. This apparent statistical discrepancy may reflect lack of uniformity in accounting and lack of transparency, which could be due to several causes:

- Differing interpretations by municipalities of accounting procedures and terminology.
- Off-budget financial operations, including reimbursable components of grants from the state budget and extrabudgetary funds inadequately recorded as revenue by some municipalities.
- Credit guarantees to budgetary and nonbudgetary organizations (and other off-budget contingent liabilities) effectively assumed by municipalities only when these guarantees were called.

The lack of uniformity in accounting and the absence of full transparency in fiscal operations (including those affecting assets and liabilities of public entities) could, at some point, represent a major macroeconomic risk. In such situations statistics tend to become unreliable, and nontransparent contingent liabilities tend to show up as direct municipal liabilities only when the obligations are called. Since nontransparent contingent liabilities have not been properly reflected in the fiscal accounting flows, there is no early warning system to indicate the level of risk to which municipalities are exposed.[5]

Composition of Municipal Debt

During the 1990s all forms of municipal debt expanded substantially: loans, bond issues, and other forms, including noncommercial loans and, especially, refundable transfers (concessional loans from the Ministry of Finance). Bond debt grew sharply in the mid-1990s (see table 28.1). Toward the end of the 1990s the Exchange Commission prohibited new bond issues as part of the general fiscal adjustment policy.[6] Except for the city of Prague, no municipal bond issues occurred between 1998 and early 2000, and the municipal bond debt has fallen slightly in nominal terms (figure 28.3). Only Prague issued, in 1999, bonds in the foreign financial market, a 200 million euro (EUR) sale (table 28.2). In the late 1990s municipalities' outstanding debt consisted of 45 percent loans, 29 percent issued bonds, and 26 percent other forms (figure 28.4).[7]

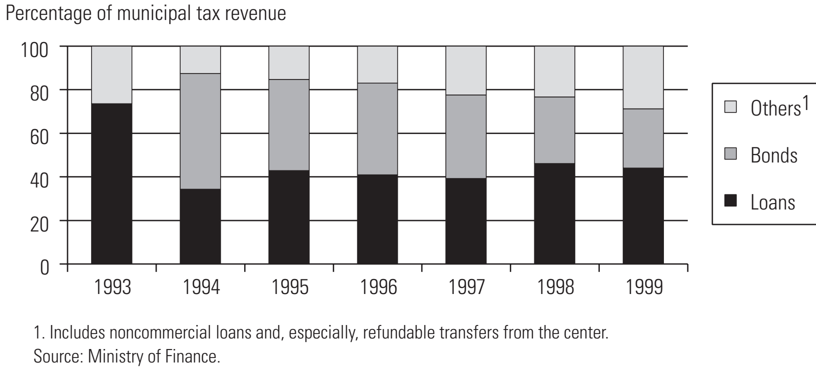


Figure 28.3. Composition of Municipal Debt Outstanding, Czech Republic, 1993–99

While most local governments have had access to bank loans and credit, only the larger cities (Prague, Ostrava, Plzen, Bruno, Liberec, Ustinad Labem, and a few others) have issued bonds. Municipal bond issues (mainly in foreign capital markets) and municipal commercial loans (mainly domestic) have been used primarily to finance public works and transport systems.

In addition, municipalities have received two types of concessional loans from the state: programmed loans (for example, to supplement the required counterpart funding for the EU preaccession structural funds[8] for investment projects) and discretionary, ad hoc loans (such as from the State Environmental Fund and the state budget). Municipal borrowing from the State Environmental Fund has financed mainly gas and water supply systems, sewerage, and wastewater treatment plants. Municipal borrowing from the state budget has been primarily for housing.

Accounts payable, another component of local government debt (for wages and salaries as well as to suppliers), does not appear to be significant in the Czech Republic.

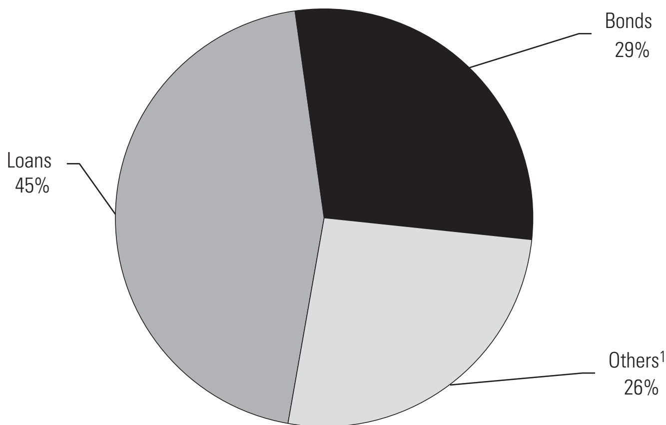
Access to Borrowing by Municipalities

Large Czech municipalities have had access to all financial markets and to the most sophisticated debt instruments for financing their investment projects. In contrast, small municipalities have had access (if any) only to

Table 28.2. Municipal Bonds Issued, Czech Republic, 1992–99

Year of issue	Municipality	Face value (millions of koruny, except where otherwise indicated)	Maturity (years)	Interest rate (percent)	Underwriter
1992	Ostrava	8.5	6	D + 1.5	City Hall
1993	Sumperk	20	5	18.00	CSOB
1994	Smrzovka	115	7	14.25	CS
	Liberec	100	5	14.25	CS
	Prague				
		7,300*	5	7.25	Nomura International
	Pardubice				
	Usti nad Labem	50	5	12.70	KB
		150	5	12.70	KB
					[Burzovni spolecnost pro]
	Caslav				
	Rikytnice nad Jizerou				
	Veseli nad Moravou	90	8	15.50	Kapitaloy trh
	Rychnov nad Kneznou	120	7	12.00	CS
		10	7	14.10	Velkomoravska banka
1995		100	7	13.10	KB
	Plzen				Bayerische
	Marianske Lazne				Vereinsbank
	Brno				Praha, ING CR,
	Frydek-Mistek				Capital
					Markets, SCFB Praha,
	Decin	500	5	11.50	KB
	Kladno	200	5	11.50	KB
	Ostrava				
1996		1,200	7	11.10	IPB
	Zidlochovice	150	5	11.80	CS
	Prague	250	7	12.50	CSOB
		250	7	12.50	CSOB
		1,318.2**	5	LIBOR + 0.2	
				[25.00]	ING Barings
1997		40	10	12.90	
1999		EUR 200 million	5	4.63	CMZRB
					ING Barings

Note: LIBOR is the London interbank offered rate.
Note: D interest rate base index.
*Valued at US$250 million. Czech Equivalent cited.
**Valued at DM 75 million. Czech Equivalent cited.
Source: Czech Republic Ministry of Finance.



1. Includes noncommercial loans and, especially, refundable transfers from the center.
Source: Ministry of Finance.

Figure 28.4. Average Composition of Municipal Debt Outstanding, Czech Republic, 1998–99

local banking and noncommercial credit sources. This difference is reflected at least in part in the vast disparity in creditworthiness between these two groups of municipalities. Large municipalities have inherited substantial assets and have buoyant tax bases, with good revenue performance from shared taxes (mainly the personal and corporate income taxes). Small municipalities have insufficient assets and meager revenue and tax capacity, inadequate to support credit operations.

Moreover, there has been a perception that the Czech commercial code restricts collateral for credit operations to assets existing at the time the debt agreement is signed—that is, that it does not recognize future revenue as collateral (Kamenickova 1999a). This perception (though not confirmed by current regulations), together with the limited tax autonomy of local governments, may be a factor in preventing small and medium-size municipalities from improving their access to financial markets. For banking sector representatives, these issues are a major concern when dealing with municipalities' credit. They have argued for allowing municipalities to have greater control over their own tax bases, in the place of continued reliance on state transfers.[9]

Nonetheless, most small and medium-size municipalities appear to be indebted—beyond their ability to service the debt. Indeed, some of the

weaker municipalities appear to be insolvent. The perception in the banking sector is that only a few small municipalities have shown good creditworthiness in the recent past, thanks to their development potential as tourist centers. Some of these municipalities (such as Jizerou, Rokytnice, and Smrzovka) are already borrowing heavily from the banking system, especially from Ceska Sporitelna (the Czech Savings Bank), and investing in tourism infrastructure.

In decentralized systems subnational governments, which are generally responsible for financing local public infrastructure, commonly rely on debt financing for capital expenditure. This has not always been the case in the Czech Republic, where the central government still plays a big part in financing local infrastructure, mainly through matching grants. Transferring this capital spending responsibility to subnational governments is an important step in developing a sense of ownership at the local level, which tends to result in better maintenance of the capital stock and greater efficiency in the use of facilities.

However, financing local capital needs entirely from local current revenues (without borrowing) would not be feasible—even if the local authorities had the desired autonomy in determining local tax bases and rates. Nor would it be economically efficient or equitable: since the benefits of these investments generally persist for several years or decades, future generations should contribute to their financing.

There is also a cash management argument: local government borrowing may be justified by the need to match nonsynchronized expenditure and tax flows within the same year. Moreover, borrowing may provide an important independent mechanism for fostering political accountability. The reason is that financial markets may signal the quality of the performance of local governments through credit ratings and interest rates charged or, in the extreme, by blocking the governments' access to credit.

Local government borrowing may be desirable as an instrument for allocating resources optimally across time and promoting economic growth and fiscal equity. Without clear rules and accountability, however, financial market failures and soft budget constraints can lead to irresponsible borrowing by local governments, which can easily turn into other problems. Local officials may be tempted to overspend on popular programs by borrowing excessively, leaving the bill for future taxpayers. Moreover, local governments that have engaged in uncontrolled borrowing might default on their debts, perhaps forcing the central government to assume these unpaid liabilities. This would pose big risks to macroeconomic stability, justi-

fying the adoption of regulations and monitoring mechanisms to ensure fiscally responsible borrowing by local governments.

Management of Local Government Debt

International experience offers several approaches to the management of local government debt from which the Czech Republic might profit when designing its own model.[10] The most common approaches include allowing financial market discipline to operate freely; using strict administrative, case-by-case control; and establishing explicit, preemptive, and legally binding general rules to prevent crises and encourage good market behavior. A combination of these options might prove most advantageous for the Czech Republic.

Market Discipline

In principle, relying on market discipline would be the most preferable approach. However, at times market discipline alone can be less effective than desired, because of market failures such as these:

- *Restricted financial markets.* Market discipline will be ineffective where financial markets are not free and open, as is the case in the Czech Republic. Common market failures are restrictions on access to foreign capital markets, which limit options, and compulsory allocation of resources (including those of official financial agencies and public enterprises) to aid the placement of government bonds.
- *Lack of transparency.* Market discipline also may fail where the availability and dissemination of information are inadequate, especially information on the amount of debt outstanding and borrowers' capacity to pay. Obtaining reliable financial information in the Czech Republic—especially for local governments—is difficult. Municipalities may not use the same interpretation of the chart of accounting, may not maintain clear and uniform registers of their assets and liabilities, and may not systematically publish and disseminate reliable information on debt and capacity to pay. Moreover, much greater transparency is needed on extrabudgetary or contingent liabilities of local governments, in the form of direct or indirect guarantees.
- *Soft budget constraints and moral hazard.* Where moral hazard permeates the public sector's relationship with the financial system, market disci-

pline can be a poor instrument for checking excessive indebtedness of local governments. Ad hoc, extraordinary, and off-budget financing and central government loans, grants, and guarantees create moral hazard. Loans and guarantees made by municipalities to municipal organizations (budgetary and nonbudgetary) may do the same.

- *Insensitivity to market signals.* For market discipline to be effective, borrowers need to show sensitivity to market signals by seeking financial policies consistent with full solvency. Rising interest rates should stop a borrower or at least cause the borrower to review a borrowing decision. As elected politicians, however, municipal mayors and heads of regional executive boards are unlikely to be concerned with market signals when deciding on current expenditure programs.

Even in mature financial markets, such as that of Canada, sole reliance on market discipline has failed to check excessive indebtedness of subnational governments. In Canada in the mid-1990s subnational government debt reached 23 percent of GDP. Subnational governments were forced to adopt fiscal adjustment programs—but only after they were excluded from the market, which entailed high social costs. In Argentina and Brazil, where the necessary market conditions were lacking, the experience with subnational borrowing in the 1980s proved disastrous. The central government had to intervene with large bailouts to rescue the creditors and avoid systemic crisis.

In the Czech Republic under present market conditions, market discipline alone is unlikely to ensure responsible borrowing from the capital market by local governments. A more effective option would be to have regulation in place that can prevent excessive indebtedness (as discussed below). To the extent possible, regulation should imitate desirable market discipline, to minimize distortions and encourage market practices in the future. In addition, the government should explicitly encourage market discipline, participation by the private sector, and development of independent financial intermediaries and credit rating institutions. The government also should encourage periodic monitoring reports by independent organizations. Reports on the indebtedness and current and prospective financial situation of local governments not only can help discipline local government borrowing but also can tend to promote the development of market institutions.[11]

Administrative Controls

Some countries exercise direct control over capital market borrowing by local governments. They may require that each proposed credit operation be ap-

proved by a central agency or prohibit local governments from accessing private capital markets directly. Central agency approval, requiring evaluation of each loan contract, tends to lead to micromanagement, bureaucracy, and inefficiency. India has used this approach to oversee state borrowing because the central government is a major creditor of the states and because the Constitution provides for such approval. In the 1980s Australia prohibited direct access to capital markets, centralizing all loans and on-lending the funds to subnational governments. However, because direct control proved ineffective, Australian subnational governments have again been allowed free access to capital markets, though their borrowing is subject to aggregate controls and the borrowing of individual governments is monitored more closely.

Central governments have generally realized that exercising direct control over local governments' credit operations is impractical. It increases the centralization of financial decisions, running counter to the fiscal decentralization goals of greater accountability by local authorities and greater allocation efficiency. It involves the central government in every credit operation of local governments, increasing central bureaucracy and administrative inefficiency, and it tends to foster inefficiencies in the financial system.

Direct control of every credit operation is not recommended for the Czech Republic, whose 6,254 municipalities and 14 new regions (2001 data) would make such an approach both costly and difficult. Moreover, an indiscriminate ban on capital market borrowing appears to be incompatible with the Czech Constitution (article 101 allows local self-governments to freely operate their own properties and budget) and with parliamentary acts establishing and regulating the regions and municipalities (Acts 129/2000 and 128/2000 empower local assemblies to decide on credit and loan operations).

Rules-Based Approach

Rules governing access to capital markets can be effective only if they are transparent, legally binding, simple to follow, and applied across the board. Such rules should include clear quantitative limits and procedural norms that respect and, to the extent possible, imitate financial market discipline and creditworthiness indicators. Many countries have adopted the rules-based approach as a preventive measure or in response to a particular situation.

To preempt systemic crises, some countries limit the credit operations of local governments by prohibiting central bank financing, financing of noninvestment expenditure, short-term liquidity assistance, and external (foreign) financing. These rules are often justified. To preserve monetary

stability, independent central banks should not provide direct finance to government, including local governments. Bank financing of noninvestment expenditure should be banned so as to force local governments to make necessary adjustments in their current revenues and expenditures.[12]

The Czech Republic should pursue restrictions on central bank financing and financing of noninvestment expenditure, but it may be unwise for it to prohibit short-term liquidity assistance and external financing. Short-term loans for liquidity assistance can allow local governments to smooth out cash flows during the year and can synchronize financial inflows with outflows. Such loans are quite common and appropriate in many countries, including Brazil and the United States. For liquidity assistance to perform its function well, however, there must be a contractually binding obligation on local governments to repay their short-term debt in the same fiscal year it is incurred.

The most compelling reasons for prohibiting local government access to foreign capital markets have been macroeconomic:

- Such operations can adversely effect monetary stability.
- A concerted approach to negotiating foreign financing could be beneficial for the country.
- The default of one entity might affect the creditworthiness of other entities and the sovereign risk rating.
- Multilateral financial institutions usually require a sovereign guarantee.

Still, prohibiting foreign borrowing would be counterproductive for promoting European market integration. Moreover, with the rapid development of market conditions in the Czech Republic, the imminent integration with the EU market, and the ongoing fiscal decentralization, an inability to access international capital markets would lead to the loss of opportunities. Thus rather than either prohibiting foreign borrowing or liberalizing it completely, it might be prudent for the time being to continue to require local governments to obtain permission from the Czech Exchange Commission for foreign loans.

The Czech Approach to Managing Local Government Debt

In the Czech Republic the central authorities have controlled municipalities' access to capital markets through a mix of market discipline and implicit government control, exercised through moral suasion of both financial institutions and municipal governments. In 1997 the Ministry of

Finance suspended authorization by the Exchange Commission of new foreign bond issues by local governments, and it has recommended that financial institutions stop lending to municipalities with a ratio of debt service ratio of 15 percent or more.[13] In addition, the Ministry of Finance has threatened to discontinue state grants and loans to municipalities that do not obey these "rules." Although banks apparently have followed the recommendations, the rules are not legally binding.

The Exchange Commission is the only formal instrument for monitoring and controlling local indebtedness. However, this institution only determines whether a domestic borrower may issue bonds in foreign capital markets; it does not monitor other types of municipal debt, including domestic debt. Municipalities face no formal limit on borrowing. Indeed, they can borrow from any source, for any purpose (even to finance current spending), and on any terms (Kamenickova 1999). Some of the financial operations of municipalities are guaranteed by official institutions (including Ceska Sporitelna), but most of these are not explicitly guaranteed, and it is unclear how creditors would recover their money in case of default. The Bankruptcy and Composition Act does not cover municipalities, and this omission may be one reason that banks have become increasingly reluctant to continue financing most municipalities.

Meanwhile, municipalities have been granting loans and guarantees to local businesses to support local development. Although such financial activities are subject to the approval of municipal assemblies, the procedures for such approvals are unclear. The lack of mechanisms for monitoring and supervising such lending has left room for soft budget constraints and also has introduced moral hazard—both features of a high-risk fiscal situation.

Options for Reform

The Czech Republic faces a clear need to develop a financial system that includes basic operational and supervisory rules designed for local government debt. This system should be aimed at promoting responsible access to capital markets while also keeping hard budget constraints in place. Also needed are institutional arrangements to improve the availability and reliability of information on local debt—to increase transparency and accountability in the system.

Reform should not require doing away with the basic legal structure allowing normal access to borrowing subject to approval by the local assembly. However, it is recommended that such borrowing be subject to

stronger supervision by the Exchange Commission, the Central Bank , and the Ministry of Finance.

The Czech government might consider the following reforms for local government borrowing:

- *Restrict loans to high-return investment expenditures* by banning medium- and long-term loans for current expenditures by local governments and by requiring full repayment of any short-term liquidity assistance in the same fiscal year.
- *Limit the debt service ratio* (the ratio of annual debt service to own current revenue) of local governments to, say, 10 percent.[14] Beyond this limit, more debt should not be allowed, because debt service commitments probably would jeopardize the normal delivery of basic public services (such as health, education, and social assistance).
- *Limit the total debt ratio* (the ratio of debt outstanding, including contingent liabilities, to total annual revenue excluding conditional grants) of local governments to, say, 80 percent.[15] Such a limit might need to be phased in. For now, the central authorities could adopt a prudent approach by allowing only gradual increases in the total debt ratio of a subnational government.[16]
- *Limit banks' portfolio exposure* to the obligations of any local government to a certain percentage of total assets. The Central Bank should apply strict norms of supervision, especially to the official credit institutions (such as Ceska Sporitelna).
- *Enact a financial emergency or bankruptcy law* clearly defining debt workout procedures for local governments in case of default, a critical need given current conditions in the Czech capital market. (A good practical example might be the bankruptcy law adopted by Hungary.)[17] Once approved, the procedures for settling local government debts should be implemented diligently. Rules will not provide a cure if they are not enforced. Putting in place a sound bankruptcy mechanism does not reduce the need for a proper system of controls and incentives to harden the budget constraints of lower-tier governments in the Czech Republic. International experience has shown that central government oversight (including, in some cases, the temporary takeover of responsibility from local authorities) remains a key source of financial discipline.
- *Adopt a law on fiscal responsibility* aimed at limiting recurrent, excessive deficits and the imprudent buildup of local public debt. Such

laws, which make fiscal authorities and managers personally, legally accountable for their decisions, create the conditions for greater efficiency, fiscal transparency, and accountability of public administration. The law should prohibit financial guarantees by subnational governments (for their enterprises or for local businesses) and central government guarantees and bailouts of local government debt. The recent fiscal responsibility act adopted by New Zealand, and especially that adopted by Brazil, could provide guidance.

- *Review the financing rules in the commercial code,* clarifying the ability of local governments to pledge future revenues as collateral for loans. Clarification of the financing rules could strengthen the financing of public budgets by forcing local governments to be more transparent and accountable and by encouraging lenders to evaluate risks more seriously. However, this reform would be effective only if it gives local authorities sufficient fiscal autonomy to determine local tax bases and rates.
- *Encourage the dissemination of risk and credit analyses* of local governments to improve transparency, foster market discipline, and promote the practice of creditworthiness analysis. In Australia, Canada, and the United States creditworthiness analysis has been a common practice, with private risk rating companies playing a central role. Credit ratings help local governments obtain necessary financing from domestic and foreign capital markets while also monitoring the risks of excessive indebtedness. Rating the creditworthiness of municipalities has just begun in the Czech Republic and should be strongly encouraged. The government can help by regularly making available reliable information on the fiscal and financial situation of municipalities.
- *Establish an official monitoring agency* to keep records and monitor the level of local government debt, including contingent liabilities. This agency, possibly under the Ministry of Finance, could carry out statistical, coordinating, and supervisory roles and play an essential part in the systematic dissemination of reliable information on the fiscal and financial situation of municipalities. It could also help enforce the fiscal responsibility law, initiate financial emergency measures, foster market discipline, and support the development of market institutions. Through these functions, such an agency would increase transparency and create an early warning system for local government debt.

Notes

This chapter draws on Fitch Ratings reports.

1. Vaclav Havel (2002) argues that in a small, open economy like that of the Czech Republic, the fixed rate regime was inconsistent with financial liberalization, and ultimately led to excessive growth in money supply. The Central Bank, which in the initial transition years lacked experience, pursued an extremely low inflation target that sent the country into recession.

2. The Maastricht criterion for fiscal discipline (article 109j(1) of the European Community Treaty) requires the ratio of the public sector deficit to GDP to be less than 3 percent and the ratio of public sector gross debt to GDP to be less than 60 percent. These are the government finance criteria, part of the European Monetary Union's (EMU) convergence criteria to which member countries submit. The other criteria relate to price stability, exchange rates, and long-term interest rates. Although compliance with the convergence criteria is not a precondition for accession to the European Union, accession does entail accepting the objectives of the EMU, and all member states must in due course comply with them permanently.

3. For example, including the "hidden" fiscal risks of the special institutions (Konsolidacni Banka, Ceska Inkasni, National Property Fund, and Ceska Financni) as well as state guarantees, the 1997–98 estimated average "true" fiscal deficit was 5 percent of GDP (rather than the conventionally estimated average of 1.25 percent), and the "true" public sector liability, excluding local governments, was 22 percent. See Polackova Brixi, Schick, and Zlaoui (2000).

4. Even if an upper-bound level of 4 or 5 percent of GDP—including contingent liabilities—is assumed, the indebtedness of subnational governments would not appear high by international standards. For example, in Germany subnational government debt was 21 percent of GDP in 1996, and in Australia it was 11 percent.

5. On the design of a warning system, see Ma (2000).

6. The Exchange Commission is a central government agency created in 1998 to regulate access to foreign capital markets and control the country's exposure to foreign debt.

7. Accounts payable of local government debt (i.e., arrears on wages and salaries as well as suppliers) do not appear to be significant in the Czech Republic.

8. The European Union Pre-Accession Funds are grants made available to EU members to promote investment in priority areas prior to their accession to the Union. In the case of the Czech Republic, these grants are oriented for environmental and transport projects, for agricultural and rural

development, and for institution building to prepare for the larger Structural Funds once the Czech Republic enters the EU.

9. During a World Bank mission in 2000 this preference was revealed in all interviews with financial sector representatives.

10. For a survey and discussion of relevant international experience, see Ter-Minassian and Craig (1997); Lane (1993); and Giugale, Trillo, and Oliveira (2000).

11. An initiative that has contributed to disciplining municipal access to borrowing and to disseminating good market practices is the *Credit Finance Analysis Handbook for Municipalities in the Czech Republic,* developed by the Union of Towns and Communities with assistance from the U.S. Agency for International Development. The handbook provides municipalities with guidance on debt management. Another initiative contributing to the development of a healthy capital market for local governments is the dissemination of analytical work on the financial situation of different municipalities, now being developed by the Czech Rating Agency. These initiatives should be strongly supported by the Ministry of Finance, through facilitating the development of reliable data by all local governments.

12. Enforcing this rule may be difficult (because money is fungible), but the amount of loans should not exceed investment.

13. Understood as the ratio of interest on debt and repayment of principal to the municipal own current revenues.

14. Here, revenue means total local government revenue excluding conditional grants.

15. The total debt ratio reflects the burden of financial obligations, which the debt service ratio alone cannot capture because of grace periods. Together, these two indicators are important for signaling the balance between present consumption and future liabilities, and limits on these ratios can protect the solvency of local governments in the long term.

16. This prudent approach is recommended in the short run, especially for the new regions that have been borne free of debt. Otherwise, the mere announcement of limits that may be sustainable in the long run may trigger adverse fiscal and macroeconomic effects in the short run, since regional politicians may want to compete for financing in the new decentralized environment.

17. Hungary's Procedure for Settlement of Local Government Debts was initially promulgated in April 1996 (Act XXV/96), with a revision approved by the Hungarian parliament on 29 February 2000. The revised act has been effective since January 2000.