



Chapter 7

Restrictions on the Issuance and Use of Subsovereign Debt

Most national governments place restrictions on the use of debt by subnational governments, thereby substituting national policy for local flexibility and the regulating effect of markets on municipal borrowing. As chapter 3 shows, there are several regimes for regulating debt, but in most cases there is an overarching set of rules that governs subnational debt issuance. National regulations typically cover the authority of subnational governments to borrow and restrict the purpose of borrowing, the maturity, the amount of borrowing or debt outstanding, the use of proceeds, and the type of security given or recourse available to the lender. While the differences can be arbitrary, short-term debt is generally that due within one year or less, and long-term debt is anything due more than a year after it is incurred. Subnational government guarantees, which ought to be treated like any other debt, also may be subject to regulation.

Subnational Government Authority to Borrow

Subnational government autonomy is generally based on principles set forth in the national constitution,¹ although the laws on subnational government borrowing are often scattered across the legal landscape, reflecting the fact that defining such activities is frequently an afterthought. Determining a subnational government's legal authority to borrow and the associated legal parameters can require reconciling conflicting laws, regulations, and decrees. Explicit authorization and procedural requirements are essential, especially where these governments have had no experience with issuing financial obligations that are valid, binding, and enforceable.

Some people argue for a minimalist approach to subnational debt legislation that gives authority to the minister of finance or other central government authority to issue regulations, to be approved by the government, so that regulations can be adapted readily to experience and circumstance (Glasser 1998). This approach may provide some flexibility in an emerging market and in a changing environment. However, over the long term, all legal criteria and conditions for borrowing should be expressly contained within the legal framework, whether as law or regulation.

In Indonesia the implementation instructions for subnational government borrowing under Law 25 mandate that donors and external government lenders conclude direct agreements with subnational governments, but the agreements must be cosigned by the Ministry of Finance. External creditors do not have an explicit right to secure their debt with the general allocation grant intercept mechanism or the right to a sovereign guarantee, but these security structures can be negotiated with the Ministry of Finance—an opaque requirement that allows for considerable political interference in the approval process (see Indonesia case study, chapter 25).

Binding Nature of Debt

A frequent issue in developing credit markets is the concern that a commitment by a subnational government may not bind a subsequent government. Even if the problem is one of market perception rather than law, the lack of clarity about who exactly is bound and for how long can create uncertainty about the political commitment of succeeding governments to repay the debt (see box 7.1). For long-term finance to be available for subnational investment, capital markets must be confident that a financial obligation is binding on succeeding governments.

In Bulgaria the law prohibits a municipal council from contracting debt or extending short-term interest-free loans within six months of the expiration of its term of office (Municipal Budgets Act, Article 40 [4]). The intent is to prevent the issuance of debt for politically popular projects that may win over the electorate while encumbering the municipality with excessive debt that will be binding on the succeeding municipal council. While this requirement has little practical effect now, given the limited municipal borrowing activity, as the municipal credit market matures it could prevent a subnational government from taking advantage of commercial financing during a period of low market rates.

If long-term debt financing for subnational investment is to become widely available, capital markets must have confidence that succeeding leg-

Box 7.1. The Philippines: How Political Risks Can Inhibit Municipal Credit Markets

In the Philippine city of Cebu a newly elected mayor publicly questioned whether his administration would be bound to honor a debt incurred by the prior council. The mayor eventually withdrew his comments, and the city paid the debt on time and in full. However, the financial community lost confidence in the city, and as a result lenders have been inclined to limit loans and bond maturities for subnational governments in the Philippines to the current administration's term of office.

To counter this maturity limitation, some subnational governments have held voluntary referendums to demonstrate popular support for specific project debt financing and thereby overcome financial institutions' fears of the political risks associated with long-term lending.

Source: DeAngelis and Dunn 2002.

islative bodies will honor the financial obligations of their predecessors. This principle should be explicitly affirmed in any subnational debt legislation. The governing law should specify the binding nature of subnational obligations to repay duly authorized debt (see examples of France and Romania in box 7.2).

Authorizing and Approving Subnational Debt

Subnational government borrowing can be approved by the subnational government executive or governing body; the community at large through a referendum; or state, provincial, or national authorities. Each approval mechanism can be conditioned by a variety of considerations, including the financial capacity of the borrower to repay debt, the purpose of the borrowing, the form of borrowing, and its consistency with national economic policy. Most mechanisms also act as a curb on local officials' prerogatives by enforcing certain disciplines and limiting their authority to borrow.

Box 7.2. Examples of Language on the Binding Nature of Financial Obligations

France, Code Général des Collectivités Territoriales (Article L.1612-15)

- The only obligatory expenditures of subnational authorities are expenditures necessary to pay debts that come due and expenditures that have been expressly determined by law.

Romania: Local Public Finance Law, 1998 (Article 48)

- Local and judet councils and the General Council of the Municipality of Bucharest can approve the contracting of internal or external loans, for a long or a medium term, for public investments of local interest, as well as for refinancing the public debt, under the provisions of this chapter.
- Local and judet councils and the General Council of the Municipality of Bucharest may decide upon contracting loans by the vote of at least two thirds of their members.
- The local public debt incurred under the provisions of paragraph (1) represents a general obligation which needs to be reimbursed, according to the agreements concluded, from the sources available to the territorial administrative unit, with the exception of special purpose transfers from the state budget.

Source: DeAngelis and Dunn 2002.

Approval by the executive. Authorization often depends on the maturity and size of the borrowing. Authorization by the chief executive seems appropriate for relatively small amounts and for the short term, where the future financial health of the local jurisdiction is not at risk. Large amounts or long-term borrowing should require authorization by legislative act of the governing body. Longer term borrowing involves trading off future financial flexibility in exchange for investment capital today.

Approval by the legislature or the community. For large amounts of debt, a local governing body should determine the key borrowing issues: for what purpose and for how much? Experience suggests that without local governing body approval, the probability rises dramatically that debt will be repudiated or that the tax or tariff changes needed to meet debt service obligations will not be enacted. Furthermore, public debate on debt policies and plans helps keep the process open and visible (see box 7.3).

Legislative approval can range from simply approving the borrowing as part of the budget process to voting and authorizing a particular transac-

Box 7.3. The City of Cebu in the Philippines Considers a Deal

Subnational governments may lack the knowledge and procedures needed to fend for themselves as borrowers with expanded opportunities. The experience of the city of Cebu, Philippines, illustrates what can happen when politics and media influence local financing decisions. The city and its mayor were actively seeking financing for a ring road, a core element of a development plan. In mid-1998, two firms, one based in Hong Kong and one in Austria, proposed that the city enter into a \$500 million loan and \$75 million letter of credit to fund the ring road. The mayor liked the idea, and the firms, eager to facilitate the process, paid several councilmen from the mayor's party to travel to Europe to see, secretly it turned out, examples of what the firms had financed. The councilmen signed letters of intent to enter into an agreement in three months.

Subsequently, things began to get sticky. Political opponents asked whether this was a scam. The local representative of the investment firms was arrested on 32 counts of passing bad checks and after posting bail skipped town for Hong Kong. Local bank officials indicated that three signatures had been forged on documents shown in the transaction, evidently guaranteeing \$150 million in city funds. The mayor established a committee to meet with the financiers, but the financiers refused to meet. By this time the Cebu scam saga was receiving daily press coverage in Cebu and Manila.

(Box continues on the following page.)

Box 7.3. *(continued)*

The mayor announced in late November that the financing consortium was embarrassed by the episode and would give the city a grant instead of a loan or at least contribute a few million pesos to the project. By the next day, however, the consortium changed its mind about any “grants instead of loans” and it was clear that the deal would collapse.

There are two perspectives on the ill-fated deal. One is that subnational governments lack the skills needed for such major decisions, so such decisions should be kept out of their reach. However, blandishments by project proponents who stand to gain (or by con artists who wish to defraud) are facts of life at all levels of government. A more positive perspective is that local party politics and news-hungry journalists are ready to shine bright lights on shady deals. A possible solution? Having local banks and bond dealers compete openly for the deal or help with the due diligence promotes disclosure and limits politically influenced decisionmaking.

Source: Petersen and Crihfield 2000.

tion and approving its terms. Special voting requirements may be employed. A “supermajority” vote by a subnational governing body has sometimes been used to demonstrate political support (see box 7.2). Such a supermajority vote can be required for certain types of subnational borrowing or for debt that is authorized just before an election, to avoid the perception of a politically motivated project.

Borrowing approval also can come from the community voting at large through a referendum. A popular vote may encourage citizen participation in decisionmaking and win community backing for the long haul, whatever the changes in the elected council. Voter approval for borrowing is not without problems, however. It adds time and expense and can turn financial decisions into political battles that may have little to do with the merits of the proposed financing. As with legislative approval, referendums may be limited to certain types of debt or special circumstances.

Approval and review by higher government level. National (or state) review and approval of subnational borrowing plans is not uncommon in emerging market economies and may be predicated on specific conditions. These could include the financial capacity to repay debt, as measured by credit analysis or a formula specified by law or regulation. Other relevant considerations include consistency of subnational borrowing with national economic policy (such as the timing of the borrowing) and the purpose and form of the borrowing. Such oversight can be used to prevent irresponsible borrowing at the local level, but it raises a number of issues. Reviews introduce delays, require oversight capacity at the national or state level, and provide an entry point for political rather than economic considerations. In general, advocates of market discipline argue that the marketplace, aided by appropriate disclosure rules, borrowing rules, and investor analysis, will do a better job of assessing financial capacity to repay debt.

There may be circumstances in which higher level review is appropriate. A state or national authority, while leaving the decisions to incur debt at the subnational level, might certify the procedures used in the borrowing process.² Certification can help build investor confidence and relieve individual investors of some of the due diligence that otherwise would be required. However, in most emerging market economies there may be little capacity at the higher levels of government to undertake this task for securities offerings. Imposing a procedural review that cannot be promptly executed slows the development of the market and opens a forum for political second-guessing and bickering.

Even where higher government approval is not routine, it might be desirable when a subnational government wishes to exceed its debt limit to have a central government entity authorize such an exception in certain narrow circumstances:

- The subnational government has a high degree of creditworthiness.
- The projects to be financed will clearly increase subnational revenues, and will be self-financing or will reduce subnational expenditures in future years and be effectively self-financing.
- The money is needed to respond to a natural disaster or civil calamity.

Additionally, some countries (for example, Ukraine) have tried to prevent “pyramid” schemes by prohibiting any refinancing of outstanding debt. Such prohibitions become problematic when a borrower experiences financial difficulties and a legitimate restructuring of debt would benefit all

parties. Provisions could be made for exceptions in such cases, perhaps with special approval procedures.

Equal Treatment of all Forms of Debt

The legal framework for subnational debt should not differentiate based on the legal form of the debt. The authorization process, debt limitation, and allowable purposes for issuing debt should be uniform for loans and bonds. The decision of a subnational government about whether to use loans or bonds should be based on market factors rather than legal factors.³ The Romanian Ministry of Finance adopted a regulation requiring its approval of subnational government bond issues (even though the Law on Local Public Finance did not require central government approval) but not of bank loans, thereby creating a legal environment favoring loans over bonds.⁴ Ukraine has substantially different authorization procedures, amount limitations, and allowable purposes for bonds, loans, and guarantees.⁵ In the Philippines loans may be taken for any purpose, but bonds may be sold only for “revenue-producing” facilities (see Philippine case study, chapter 26).

Details relating to the terms of subnational debt, such as maturity and interest rate limitations, are often not expressly set forth in the legal framework and so are open to interpretation. An area under intense scrutiny in many emerging market economies is the currency composition of the debt (see the South Africa case study, chapter 18). Except in unusual circumstances, subnational governments have limited ability to raise foreign currency funds themselves and are poorly positioned to hedge or speculate against currency fluctuations. Sofia, Bulgaria, used a U.S. dollar-denominated loan to fund the purchase of buses in 1994. During the term of the loan, the exchange rate rose from less than 30 lev to the dollar to more than 3,000 lev to the dollar. Subnational governments are often exposed to such risk through the on-lending programs of multilateral and bilateral lending programs. Subnational governments have sometimes been charged loan premiums for currency risk protection and in other cases have simply borne the risk directly, though often the risk has been mitigated by sovereign guarantees. Central government approval is often required for subnational government assumption of currency risk, which seems to be a sound policy.⁶

Restrictions on Short-Term Debt

Short-term financing can be a useful part of a subnational government’s regular operations. It can be used to cover operations in anticipation of an-

nual tax revenues or of nonrecurring revenue, such as from the sale of assets, receipt of a grant, or issuance of long-term debt. Operating expenses can be financed from borrowed funds or from a municipality's working capital, which usually is less expensive and more reliable, but not all subnational governments maintain adequate working capital funds. In that case subnational governments generally either match outflows with inflows or attempt to get advances from the national treasury, as in Romania.

Events can slow the receipt of revenues or cause unexpected surges in spending that lead to cash shortages. Ideally, governments would carry reserves to smooth fluctuations in working capital flows, but liquid reserves can be a source of political bickering and a temptation to politicians with other priorities. In some countries surplus funds are returned to the central government for redistribution or are held in non-interest-bearing national treasury accounts, yielding no benefits to subnational governments from investing surpluses.

Borrowing to meet short-term financing needs can provide opportunities for banks and subnational governments to develop working relationships and allow bankers to become familiar with the governments' financial affairs. Provided that the financing is repaid within the budget year and that carrying debt beyond the budget year is prohibited, there is no *a priori* reason to limit such financing to capital spending.

Dangers of Misuse

A major concern is that short-term debt will be used to bridge an ever-growing gap between recurring revenues and recurring expenditures, reaching levels that compromise a subnational government's ability to deliver basic services. The "snowballing" of short-term debt as governments run chronic operating deficits has been a leading cause of financial emergencies, causing banks and other investors to lose confidence in a government's ability to run surpluses and repay its short-term debt. Allowed to accumulate too long, short-term debt can reach unsustainable levels, requiring a high proportion of revenues to be devoted to debt service at the expense of public services. Eventually, creditors may deny further credit extensions when they perceive that the floating debt has reached excessive levels (see box 7.4). This happened to New York City in the 1970s and more recently to subnational governments in Argentina, Brazil, and Mexico, contributing to financial crises.

Nature of Restrictions

Short-term borrowing should be restricted to financing intra-year cash flow budget deficits. The debt should be repaid within the budget year, with no

Box 7.4. Johannesburg Comes Up Short

South African municipalities may legally borrow to finance both routine and unusual short-term needs, but they are required by the national constitution to settle their short-term debts by the end of the fiscal year. The usual form of borrowing has been a bank overdraft, which creates an unsecured debt. In some cases, the overdrafts were not being settled as required by law at the end of the fiscal year. For Johannesburg, curing the snowballing short-term debt problem led to other problems for the nation's financial sector.

In 1997 Johannesburg found itself in a difficult position. It had accumulated a large amount of outstanding short-term debt to finance the start of a capital spending program that was to have been funded by the sale of long-term debt. Domestic markets closed to the city in late 1997. Ultimately, the Development Bank of Southern Africa (DBSA) stepped in and made a loan secured on a specific tax source.

However, the rescue had its repercussions. The South African commercial banks, which had refused to roll over the short-term loan, were disturbed that the DBSA had "peeled off" part of the general revenue base and had done the deal on terms that were only marginally better than they were offering.

Source: Authors.

refinancing beyond the end of the budget year. The volume of short-term borrowing also can be limited, with a ceiling set at some percentage of total budget revenues (see box 7.5 for some common formulas). Lithuania and Romania limit short-term debt to 5 percent of revenues.

A further protection against excessive debt accumulation is a requirement that short-term borrowing be paid off in full at least once a year, with appropriate safeguards against immediate re-borrowing. Because natural disasters or financial emergencies may make this difficult to enforce, some provision for national-level approval of exceptions might be needed.

Restrictions on Long-Term Debt

Long-term debt allows subnational governments to acquire or build capital improvements more quickly than they could on a pay-as-you-go basis. It allows more equitable payment schemes, since users can be made to pay for the capital cost of facilities as they are used over time. However, there are also costs and risks. Long-term debt limits a subnational government's future budget flexibility. Unwisely used, it can burden citizens with high taxes or service charges. Many countries permit long-term debt only for capital spending and not for operating deficits (sometimes called the "Golden Rule"). Some countries are even more restrictive, limiting bonds to "self-supporting" revenue-generating activities, as in the Philippines. Underlying these regulations is the conviction that governments should only borrow long term when the proceeds of the debt will contribute to some future capacity to repay.

Competing Prescriptions for Long-Term Debt Use

Long-term debt is clearly appropriate for capital investment when the term of the borrowing is related to the useful life of the capital asset being built or acquired. Less clear is whether multiyear debt should be allowed for other purposes in many developing countries, such as work-outs as part of a fiscal recovery package or extraordinary expenses related to the transition and restructuring of governments.

Typically, regulation of the purpose of long-term debt either allows subnational governments to borrow for any public purpose authorized by law—leaving it to the local jurisdiction to decide what is wise and appropriate and to the markets to decide whether the stated purpose is worth financing—or limits borrowing to specific public purposes. These might include:

- Building or acquiring a capital asset whose anticipated useful life will equal or exceed the term of the borrowing.
- Funding self-supporting revenue-generating projects.
- Funding accumulated operating deficits as part of a legal or administrative restructuring.
- Funding extraordinary needs, such as recovery from natural or human-caused disasters.

Each alternative has its advantages. Two factors favor a more liberal authorization policy. First, subnational government finance is an evolving art, and

there should be room to adopt new forms and techniques of local finance. Second, if national policy favors decentralization (the operating premise of this book), then local managers should have decisionmaking flexibility. However, some restrictions may be appropriate for nascent subnational government debt markets. Specific limitations can provide clarity about what is permissible, which may reassure young capital markets, particularly where there is a perception that the public needs protection from politicians or managers who might try to use long-term debt for their own short-term gain.

Public Purpose Debt: Distinguishing between Public and Private Benefit

A frequent issue is the evolving standard for “public purpose” and the creation of legally defined boundaries distinguishing private and public benefit. The limited debt capacity of many subnational governments in emerging markets might best be devoted to projects that clearly serve a direct public purpose. Yet many subnational governments have inherited activities and facilities of a commercial nature, including ownership and operation of entrepreneurial businesses. Moreover, many reformers call for subnational governments to involve the private sector in the delivery of goods and services and the ownership of facilities. Such public-private engagements can rapidly turn to questions of how the subnational government can provide guarantees or even loans to make the facilities more attractive for private ownership or operation. In other words, both customary and new ways of “doing business” compound the difficulties of making bright-line distinctions between public purpose and private benefit.

The governing law should distinguish between debt issued for a public purpose and debt issued for a publicly owned, but inherently private, entrepreneurial activity. In defining “public purpose,” debt legislation should prohibit general obligation debt or subnational guarantees for the benefit of such private entrepreneurial activities. Sometimes a public purpose clause in the subnational debt legislation also explicitly prohibits the use of subnational borrowing authority to incur an obligation solely or primarily to benefit a private property owner or a business.⁷ This can preclude issuing debt for the types of public-private projects being considered in many emerging market economies in which assets are to be transferred to the private sector or jointly operated by the public and private sectors.

Thus the standard for what constitutes a public purpose may be difficult to define in many contexts. Financing certain private entrepreneurial activities can be argued to have an indirect public benefit, such as increased em-

ployment, economic activity, or housing. This standard may be an appropriate issue for regulation, which should provide the necessary flexibility. The standard could initially be defined very conservatively and later expanded. Additionally, an argument could be made that, although the nature of the project is not directly related to a subnational unit's ability to pay the debt, creditors would rather be associated with a public purpose project that enjoys general political and popular support and enhances a subnational government's willingness to pay the debt associated with such a project.

Regulations concerning the public purpose need to be carefully phrased with provisions such as the following:

- The public purpose is paramount in the expenditure or loan, any private gain must be incidental to achieving that purpose, and such gain must be of a customary and appropriate degree.
- Financing that extends beyond the current budget year may be issued solely for investment or refinancing of debt issued for investment that serves a public purpose authorized in the municipal budget.
- The proceeds of a borrowing may be spent only on the investment for which the debt has been authorized, unless both the subnational governing body and the debt holders agree otherwise.

Restrictions on Amount of Debt

There is little agreement in practice on the amount of debt that a subnational government should be allowed to carry. A review of the case studies (chapters 14–31) shows that approaches occupy a spectrum: at one end is Hungary (chapter 29), with a Law on Local Self-Government that gives subnational governments unlimited borrowing authority; at the other end is the Republic of Korea (chapter 23), with very detailed borrowing criteria involving multiple measures of debt service and requiring higher level approval of individual issues. An International Monetary Fund publication (Ter-Minassian 1997) argues for rules-based control of subnational borrowing, with limits on the debt of individual jurisdictions that “mimic market discipline.”⁸ Such control could be framed in terms of a ratio between maximum annual debt service and a conservative projection of the revenues that would be available to pay debt service.⁹

The argument against such control is that there can be occasions when it is desirable for a local jurisdiction to temporarily exceed a given ratio as it

invests for the future or spends down accumulated reserves. The argument favoring such control is that it protects the public from reckless borrowing by officials or elected representatives who may not be sensitive to the long-term risks.

Distinguishing General Fund and Limited Obligation Debt

For general fund debt an allowable ratio of outstanding debt or debt service to available resources for repayment can be set to provide reasonable protection without interfering with sound management. An escape clause could permit the debt limit to be exceeded for exceptional cases under emergency legislation or with special permission from higher level authorities (or local referendum, as in the United States). For self-financing or enterprise projects, where the pledge is clearly limited to project revenues, the debt limit need not apply. However, few emerging market economies make this legal distinction for limited obligation debt.

Some Practical Problems in Designing Limits

Limitations on subnational debt are widespread. Common debt limits are on the following:

- The amount of indebtedness issued, usually expressed as a ratio of actual or potential source of revenues, such as taxable property values.
- Annual debt service as a percentage of uncommitted annual revenue, most commonly 15 percent of recurring revenue.
- Short-term indebtedness, generally to mature within one fiscal period but often violated in practice.
- Long-term borrowing is restricted to capital investments and borrowing in foreign currency is prohibited.

Provisions are frequently open to differing interpretations, and enforcement can be uneven and fractious. Poland provides an example. In Poland, Regional Audit Agencies are charged with ensuring that cities comply with borrowing restrictions, but interpretations have been inconsistent. Although the borrowing law is silent on the agencies having oversight for project selection, cities and regions often have argued over the desirability of specific projects.

The main reason for ambiguity is that legal limitations on debt are not adequately detailed in regulations, leaving several questions about their application:

- Is it the debt service installments (principal and interest) payable in any single year that may not exceed the designated percentage or the total principal amount of the debt at the time of borrowing? While the intention would appear to be to limit debt service installments in any single year, the language often expressly refers to the “borrowing.”
- If the test is based on annual debt service, exactly how is the formula calculated for future years? What assumptions are to be used for debt service when the interest rate is variable? What assumptions are used to predict future revenues?¹⁰
- If compliance in subsequent years is not tested at the time of issuance, what is the effect of violating the debt limitation in a future year? Is there any impact on the validity of the debt? What would prevent debt structures that defer a substantial portion of the principal repayment to later years?

If not clarified, these issues can cause substantial confusion, permit political skirmishing, and create barriers to the development of a credit market for subnational borrowing.

The annual debt service limitation should be tested at the time of issuance; if the debt service is within the limitation, it should not be subject to claims of violations of the limit in subsequent years. Each annual installment can be calculated as a percentage of the total current revenues of the budget in the year in which the debt is issued (or the prior year, if the data are more verifiable), assuming the interest rate at the time of issuance (providing it is based on an independent index, to prevent use of an artificially low rate to achieve compliance with a debt limitation.) This interpretation would be an incentive for “substantially equal annual debt service.”

Many transition economies have restricted debt service to a percentage of budgeted revenues (table 7.1). Poland holds annual debt service to no more than 15 percent of budgeted revenues. Debt carried beyond the current year may not be greater than 60 percent of budgeted revenues.¹¹ The limit on annual debt service falls to 12 percent when total public debt (sovereign and subsovereign) hits 55 percent of GDP, and further borrowing is prohibited when the total hits 60 percent of GDP, the EU standard. Romania limits the annual debt service of subnational governments to 20 percent of total current recurring revenues, including the shared wage tax.¹² Lithuania holds borrowing to 10 percent of current revenues.

Table 7.1. Municipal Debt Limitations in Selected Eastern and Central European Countries

Country	Debt service ratio limit	Borrowing-to-revenue ratio limit	Other restrictions
Hungary	70 percent of own current revenues (local taxes, fees, interest revenues, environmental fines). Debt service includes potential liability under guarantee commitments.	None.	<ul style="list-style-type: none"> Subnational governments with outstanding loans and expenses of more than 100 million forints must have external independent audits. Loans cannot be secured with primary assets, general transfers from the state, shared personal income tax. Debt-service restriction does not apply to short-term liquidity loans.
Lithuania	10 percent of total revenue, excluding earmarked grants.	Borrowing cannot exceed 10 percent of total "revenue" in a approved budget (excluding earmarked grants); there is a sub-limit of 5 percent for short-term borrowing.	<ul style="list-style-type: none"> Debt stock is limited to 20 percent (30 percent for Vilnius) of total revenue. Short-term loans must be repaid within fiscal year. There are no state guaranteees. The Ministry of Finance can impose lower borrowing ceiling for individual municipalities based on budget performance. Long-term credit can be used only for investment and must be approved by a loan commission of the Ministry of Finance.
Poland	15 percent of total revenue (debt service includes potential liability under guarantee commitments).	None.	<ul style="list-style-type: none"> Short-term loans must be repaid within fiscal year. There is no state guaranteee, unless explicitly stated. Long-term credit is only for investment. Carry-forward of unpaid principal on all debt to next budget year cannot exceed 60 percent of budgeted revenues.
Romania	20 percent of current revenues.	None.	<ul style="list-style-type: none"> There is no state guaranteee; debt registration documents must include a clause to this effect. Debt incurred must be reported in the public debt register and reported annually. Short-term cash balance loans are limited to 5 percent of total revenues. External borrowing must be approved by a loan authorization commission.

Source: DeAngelis and Dunn 2002.

Central Government Review and Exceptions

Laws governing subnational debt sometimes provide for central government authority to review and approve requests to exceed the debt limit when the subnational government can demonstrate that its local revenue base would support a greater amount of debt. Exceptions might include:

- Additional financing for more creditworthy subnational governments.
- Financing of investments that have a positive net impact on cash flow either by generating increased revenues or by reducing operating expenses; examples are utility and energy conservation projects.
- Natural or civil calamity.

Considerations of Security and Collateral

Authorizing the use of various forms of security and collateral to secure subnational government obligations is an important part of the legal underpinnings of a subnational credit market. In view of the imperfect security provided by a general obligation pledge, subnational borrowing is often reinforced by additional, specific pledges of revenue, property, or a third-party guarantee. Some projects that have the potential to be “self-supporting” may not require the pledging of general credit.

Revenues

A subnational unit should be legally authorized to pledge to a creditor specified revenues over which it has spending discretion. The revenues should be identifiable and held apart from other funds. A creditor should have a first-priority secured position to such revenues, a critical element in the structure of a revenue-secured debt. Lack of experience with such pledges and with judicial recognition and enforcement creates uncertainty. It is clearly advantageous to have an express provision in the law for subnational governments to secure their loan repayments with identifiable future revenues and to ensure a creditor that it has a first-priority secured position to such revenues.

While a legally protected pledge is important, its absence has not precluded subnational borrowing when alternative arrangements have been available. Banks have loaned to subnational governments that deposit their funds (or some portion of them) with the bank. The possession of these deposits, backed up by a right of offset, reduces the risk that arises from not having a legally protected pledge.¹³

Physical Property

The ability to sell property is essential to the ability to pledge or mortgage property to secure a loan. However, the authority for subnational governments to use property as collateral is often clouded in legal uncertainties. Some countries have clear distinctions between subnational property in the “public domain,” which is used to carry out mandated government functions, and property considered to be in the “private domain,” which is unrelated to such essential government functions. Private domain property may be encumbered or otherwise disposed of, but public domain property is “inalienable.”

The value of property as collateral also depends on the legal procedures to be followed by a creditor in case of a default. If it takes several years to foreclose on property, its value as collateral is substantially diminished. Often, procedures relating to subnational property have not been established or have not been used enough to create a reasonable expectation based on precedent.

Whatever the legal status of these issues, in many countries there appears to be a consensus that a subnational government may sell or otherwise encumber property that is not used in carrying out its mandated services.¹⁴ Such practical understanding of the parameters of this authority seems to be based more on historical practice than on legal provisions. So even if the authority to use physical property as collateral is unclear, banks often lend on the basis of physical property as collateral since banks are familiar with this type of collateral. Additionally, bank regulatory requirements often establish preferred capital reserve requirements for loans secured with physical property. Property in the private domain that is owned by subnational governments may be sold or otherwise encumbered to secure debt.¹⁵

Intercepts

One of the most used and effective forms of security for subnational debt in emerging markets is an intercept provision. Intercepts give a lender a first claim on intergovernmental transfers due to the subnational government in the event of nonpayment. A number of countries specifically use legislatively authorized intercepts of intergovernmental transfers to enhance the ability of subnational governments to offer reliable security for their borrowing. Depending on the size and continuity of the transfers, intercepts can provide strong encouragement of credit market development without any implied central government guarantee or other cost to the na-

tional treasury. Thus intercepts merit particular consideration in the development of subnational borrowing policy and law.

Intergovernmental transfers are of several types. Some give subnational governments a specified portion of national tax revenues. Others are distributed not by formula but through annual appropriations by the national legislature or as a percentage of national revenue raised in each region or locality. Still others are provided as subsidies for specific projects (Bahl and Linn 1992). In the initial stages of credit market development, the share of the revenues derived from the central government pursuant to an established and reliable formula is often a preferred source of security for lenders. This form of security has opened the credit market to subnational governments that otherwise would not have access to it and lowered their interest costs.

Contractual intercept provisions must be carefully drafted to prevent abuse and overuse. Subnational governments can come to rely on the intercept rather than on the discipline of making timely debt payments. If the intercept law is too permissive, an ambitious mayor and council can tie up a disproportionate portion of a subnational government's main revenue sources for years to come, jeopardizing mandated service delivery.

In some countries problems arise because the central government and private lenders cooperate too closely in the administration of intercepts. The central government may make automatic payments to the commercial lender from a subnational government's allocation of a shared tax and then transfer only the residual funds to the subnational government, without any clear accounting for the intercept. To prevent this, the following assurances are important as part of applicable rules and regulations:

- That the subnational government not only enter into the intercept arrangement voluntarily but be in control of negotiating the specific terms and conditions.
- That there be clear conditions for when the intercept would be activated; the intercept should operate only in the case of defaults, not as a substitute for regular payments.
- That, at a minimum, the transferring government provide a clear accounting for any intercept funds diverted to a lender. Alternatively, intercepts can be administered through a special fiduciary arrangement established at the local level.

To discourage subnational governments from over-reliance on the intercept to cover delinquent debt payments, consideration can be given to lim-

iting or imposing a financial penalty each time the intercept is used.¹⁶ Also, to preclude any future question of an implied central government guarantee, the legislation might explicitly state that no central government guarantee is to be inferred for such credit without explicit central government authorization. The law could require that each subnational debt instrument contain a statement on its face that there is no express or implied central government guarantee and that the instrument does not represent any obligation of the central government (see boxes 7.5 and 7.6 for sample language).

Box 7. 5. Example of Language Denying Central Government Responsibility for Municipal Debt***Romania Local Public Finance Law 1998, Article 50***

- (1) The local public debt does not represent a debt or responsibility of the government, and it shall be reimbursed exclusively from the revenues through which the respective loan was guaranteed by the authorities of the local public administration.
- (2) The documents registering the local public debt shall include a clause through which the respective territorial administrative unit places itself under the obligation to reimburse the debt, and to pay the interest and the commissions associated with that debt exclusively from the revenues of the respective local public authority; the government has no payment obligation whatsoever, and the credibility or taxation capacity of the government must not be used for guaranteeing the reimbursement of the debt contracted by the territorial administrative unit or of the payment of interest or commissions associated with that debt.
- (3) The documents registering the local public debt which do not comply with the provisions under paragraph (2) shall not be considered as valid.

Source: As quoted in DeAngelis and Dunn 2002.

Box 7.6. Example of Language on Securing Debt with Own Revenues

Lithuania, Decree on Usage of Bank Credits by Local Authorities, 1998, Article 14

- When taking a loan, the municipality must guarantee its repayment only by the means of the municipality budget, and the municipality enterprise, only by the assets, which could serve as a source to recover the loan.

Romania, Local Public Finance Law, 1998, Article 49

- (1) The due installments deriving from the contracted loans, the interest and commissions due by territorial administrative units, shall be provided in the local budget.
- (2) The loans contracted by territorial administrative units can be guaranteed by the local public authority, from any revenue source, with the exception provided under article 48, paragraph 3. Any guarantee by revenues is valid and shall apply from the moment the guarantee is offered; the revenues representing the guarantee and which are collected by the local budget shall be subject to the respective guarantee agreement, which shall apply with priority against any other request of third parties addressed to the respective local public authority, irrespective of whether these third parties are aware of the guarantee agreement or not. The document through which the agreement of guaranteeing through revenues is concluded must be registered with the city hall or with the respective *judet* [county] council, and with the debtor.
- (3) All loan agreements concluded according to the provisions of this law shall be considered as fully authorized and shall constitute obligations to be enforced on the respective local budgets.

Source: As quoted in DeAngelis and Dunn 2002.

Reserve Funds

A reserve fund, segregated from other funds of the subnational government and available only for debt payments should the government run into payment difficulty, enhances debt security. Governments should consider creating such a fund for securing debt. How that fund may be invested and by whom it shall be kept are important considerations.

Subnational Government Guarantees

In many emerging market economies subnational guarantees of municipally owned utility enterprises are a common financing device. Because these and other contingent obligations can present problems for controlling subnational debt, the guarantee should not be a mechanism for incurring debt indirectly that could not be incurred directly. Guarantees of third-party debt by subnational governments should be as follows:

- Authorized in the same manner as subnational debt.
- Restricted to projects in the public interest for which subnational debt could be issued.
- Limited to third parties created or controlled by the local government.¹⁷
- Counted toward the debt limitation in the same manner as direct debt or as a percentage of the amount until a payment is made on the guarantee, when the full amount would be allocated. The initial percentage could be based on some determination of the creditworthiness of the guaranteed party, although creating such credit distinctions may be too sophisticated a process in a new subnational market.

Notes

1. In Poland, for example, decentralization and self-governance are key constitutional principles (Constitution, Article 16.2). The Constitution of South Africa provides that the “executive and legal authority of a municipality is vested in its municipal council” (Section 151 [2]). Chapter 9 of the European Charter on Local Autonomy calls for local authorities to have access to capital markets to borrow the funds needed for capital investment.

2. In the United States, the bond counsel (a law firm specializing in municipal bond transactions) often drafts the needed resolutions and con-

tracts and provides opinions on whether the transaction conforms to applicable laws and regulations. Some states in the United States also have procedural checks. Texas local government issuers must obtain approval on procedures but not on use of proceeds or other substantive matters from the Office of the Attorney General before issuing debt. The office reviews the proposed bond issue's supporting documentation, certifies validity, and issues an opinion. The opinion is needed for the bonds to be legally binding and relieves individual purchasers of the need to inquire into the process by which the bonds were issued. Oregon requires that localities prepare bond documents following recommended guidelines. Many states require that prospective sales be reported to a central office and placed on an official calendar. North Carolina requires a filing and approval before sale, largely a procedural matter.

3. Certain forms of debt may nonetheless have additional legal requirements relating specifically to their form. For example, a publicly offered bond issue should be required to conform to standards of appropriate disclosure to investors.

4. This requirement has subsequently been repealed by the Ministry of Finance.

5. Law on Securities and the Stock Exchange, Law on Local Self-Government and the Budget Code.

6. In Romania a Government Debt Commission has been created to "approve" any local government debt issued in a foreign currency (Law on Local Public Finance, 1998). In the Philippines a Monetary Board "render[s] an opinion of the probable effects of the proposed operation on monetary aggregates, the price level, and the balance of payments" (Central Bank Act, Republic Act No. 7653, Sec. 123).

7. The Romanian Law on Local Public Finance allows only projects in the "public domain" to be financed with debt (Article 48 [1]). The Vietnamese Law on the State Budget authorizes a province or city to finance only infrastructure investments.

8. Teresa Ter-Minassian, editor, *Fiscal Federalism in Theory and Practice*, Washington DC, International Monetary Fund, 1997, pp. 171–172.

9. Although many government's debt ceilings are expressed in terms of the debt principal outstanding in relationship to either a measure of tax base or revenue flows, the best prescriptions are likely to use annual debt service in relationship to available revenues. Actually crafting such a restriction calls for considerable care in definitions. See Charles Smith, "Measuring and Forecasting Debt Capacity: The State of Oregon Experience,"

Government Finance Review (December 1998), pp. 52–54. As Smith points out, the legal limit is usually much higher than the effective market limit.

10. A debt limitation is most effective when it is an “issuance” test rather than a “continuing compliance” test that may be violated in subsequent years. Unfortunately, many such debt limitation provisions are written as requiring compliance in each year.

11. Law on Public Finances 1998, Articles 113 and 114.

12. Law on Local Public Finance 1998, Article 51).

13. In certain transitioning economies the formerly centrally owned banks have retained powers of offset on deposits that put them at the head of the line of creditors. In other countries the ability of the banks to exercise offset powers is limited, and depositors may elect to sever their relationships and withdraw funds. Where banks possess considerable powers to enforce security, they may stifle competition from the bond markets. They may assist the development of bond markets by acting as trustees on behalf of bondholders.

14. In Latvia local governments are expressly prohibited from guaranteeing a loan “with property that is necessary for the performance of governmental functions.”

15. The requirement of a “public purpose” and the limitation on collateral to be in the “private domain” may effectively prevent the use of a financed project as collateral for the debt issued to finance the project.

16. In the Philippines local governments may pledge no more than 20 percent of “internal revenue allocations” (Local Government Code, Sections 287 and 324 [b]).

17. In Latvia, a local government cannot guarantee the debt unless it owns at least 50% of the borrower.(or an association that is at least 65% subnational-unit owned). Regulations of the Cabinet of Ministers on Self-Government Borrowings and Guarantees, 4/2/97.