Executive Summary

Raising capital for investment in infrastructure facilities is a universal concern in developing and transitioning economies. These long-lived facilities are crucial for building healthier, better-served populations and for creating competitive economies. Properly planned, operated, and maintained, such investments provide benefits for many years. However, in these countries long-term capital is scarce and has many claimants.

The challenge to raise funds comes at a time of transition and uncertainty. Devolutionary changes in the scheme of governance and dispersal of fiscal decisionmaking are pushing down responsibility for meeting capital needs and for subsequently operating facilities to a vast array of provinces, cities, and villages. Concurrently, there is increasing pressure to make government at all levels more accountable to citizens and more attuned to the demands of the marketplace. This sensitivity to market behavior in the face of limited resources includes the drive to make more activities self-supporting, to curtail the provision of free service, and to shed services that the private sector can provide better.

A critical issue in this transfer of responsibility and fiscal resources from the center to subnational governments is how to increase the access of subnational governments to financial markets, broadly defined as the banking system and the securities markets. The word *markets* implies a system with a variety of borrowers and lenders and with credit allocation based on pricing decisions that balance supply and demand. It also implies an array of alternatives for accessing capital funds. Accordingly, the development of financial markets is an important objective for developing economies. As economies develop and financial markets mature, markets are expected to evolve to bring together subnational needs for investment capital and the supply of funds. Will that happen?

This book explores markets for subnational government debt and the successes and failures that emerging and transitioning economies have experienced in promoting the development of such markets over the past decade. It assesses these experiences and extracts lessons to inform future efforts to establish and strengthen local government access to credit and improve the chances for success.

The book has six parts. The first five parts establish an analytical framework for studying the way subnational government credit markets function, the kinds of credit instruments and security arrangements available, and the main participants in the market. From this analysis, much of which deals with the technical design of transactions and the attributes of debt instruments, come a number of findings that form the basis for policy guidelines. Part six is a series of country-based studies that review the experiences of building markets for local government debt. These studies show that a large variety of economic and institutional settings influence the nature and extent of local government borrowing, from large-scale borrowing in international markets to building more effective state-sponsored intermediaries.

The Analytical Framework

The analytical framework examines the components of the supply of and demand for subnational debt, noting several perspectives from which to assess the feasibility and desirability of introducing local government securities to credit markets.

Part 1. Political, Legal, and Financial Framework

Credit needs and market structures vary greatly and depend on the political, fiscal, financial, and legal settings in which they are embedded. Chapters 2 and 3 examine the tensions and difficulties caused by the devolution of fiscal systems and the risks associated with the decentralization of borrowing decisions. They discuss the needs for a hard budget constraint, managerial capacity, and transparency and ways to achieve them to promote effective markets. A description of the levels of financial market development and the frictions in creating new financial markets and greater competition among credit providers sets the scene for later chapters. Also explored are legal systems and their ability to support the operation of markets and to understand the contracts they must enforce.

Part 2. Borrowing Instruments and Restrictions on Their Use

Borrowing is at heart an economic activity played out in financial markets. It is technical, with its own nomenclature and methods of analysis that revolve around balancing risk and rewards. Chapter 4 discusses the characteristics of potential subnational borrowers and what qualifies them as candidates. It walks through the wide variety of subnational government structures and conditions, noting that many localities are too poor and too small to have the need or the resources to borrow in markets. In many other cases both the need and resources are there, but inexperienced and immature governments require help to become creditworthy borrowers, a subject that reemerges later. The discussion concludes that, while needs and capacities differ, it is best not to prejudge by overly restrictive classification systems. Where possible and with appropriate help, market access can help instill fiscal discipline and responsible behavior.

Chapters 5, 6, and 7 lay the foundations for the kinds of borrowing that may be undertaken by subnational governments and explore the nature of the resources that can be pledged to repay indebtedness. They examine the variety of borrowing instruments, their technical design (maturity, interest payment schemes), and the methods by which they are offered to the market. Markets with sufficient competition and transparency should be allowed a good deal of flexibility in setting the parameters of individual transactions within a general framework of widely shared rules. The corollary is that the more developed a market is, the more it can be relied on to enforce the "rules" for subnational borrowing.

Chapter 7 also turns to authorization and approval of subnational debt and the limitations that may be placed on its use and magnitude. The chapter examines the legal and market issues related to the various types of security that may be pledged. A review of the wide variety of restrictions and possible pledges argues for avoiding ill-designed, overly restrictive cures that can cause more harm than good.

To ensure that transparent procedures and overarching prudential restrictions are as useful as possible, there should be regularized rules that leave room for market-based determinations. Furthermore, notions of security must reflect the needs of financial markets, including sure and speedy remedies when transactions go awry. While comprehensive borrowing laws are a desirable end result, their construction should be incremental, occurring as borrowing needs arise and loan contracts are drafted. While not everything needs to be in place before markets can operate, participants should be mindful of elements that are still a work in progress.

Part 3. Characteristics of Financial Market Regulation and Disclosure

Chapters 8 and 9 consider the structure, operation, and regulation of the domestic financial markets in which subnational governments seek to borrow. Domestic credit markets are often small, have few participants, and are easily overwhelmed by the demands of the sovereign and the banking system. A recurring theme is the difficulty that markets have in matching governments' long-term borrowing needs with the limited investible funds and the short time horizons of investors. However, the types of investors that may be interested in purchasing subnational government debt are growing in rank and importance.

Also examined are the links between domestic financial markets and international markets. The emerging bond markets, recently viewed as a promising alternative source of funds, languished after the world monetary crises of the late 1990s and subsequent economic slowdown. Those markets, while sidelined, continue to have enormous potential capacity. However, until the international monetary system demonstrates greater stability and financial markets improve, the ability to tap that capacity is constrained by strong aversion to the risk found in emerging market credits.

Part 4. Evaluating, Monitoring, and Assisting Subnational Governments

The operation of financial markets depends on assessments of the creditworthiness of market participants. Only in that way can risks be judged and offset by adequate rewards. As chapter 10 details, a major concern in emerging markets is assessing the operations and financial conditions of subnational government borrowers as a basis for assessing risk to investors. The archetype of such assessment, or credit analysis, is the opinions of rating agencies. Their practices and the influence of their opinions are examined in chapter 8. Relying on credit ratings presents major issues for small and emerging financial markets where skills, resources, and markets for opinions are limited. Still, the value of the rating process in enforcing disciplined behavior can be great. The chapter also briefly examines the use of private credit enhancements, in particular, the use of bond insurance. Because of the uncertainties in emerging markets, the dominant private sector firms have shown little interest; however, some important homegrown applications have been found in emerging markets.

Chapter 11 discusses how surveillance and analysis of credits by markets can complement and benefit from the monitoring of subnational governments by higher level governments. The information produced in a good monitoring scheme is useful to market and government officials at all levels. In addition to illuminating how well governments are performing, such information is critical for enforcing prudential regulations. In practice, however, periodic financial reporting is a weak spot, often because it is not considered essential. Efforts to regularize and harmonize reporting and improve its content are indispensable to market development.

A related area is what the national government does when faced with local financial emergencies. Devising techniques that allow intervention to protect vital services, while seeing that weak budgeting and risky behavior by subnational governments are punished, is a difficult but necessary part of enforcing a hard budget constraint. A clear process for handling such circumstances and restoring local financial health reduces risk to markets but softens the budget constraint. Similarly, passing too much of the risk to the creditor can stifle market growth. Finding the right balance is the issue.

Chapter 12 focuses on how to assist subnational governments in gaining access to credit markets. The process faces a number of pitfalls and limitations, not only among prospective borrowers but in the markets themselves. The design of credit assistance programs must deal with the fact that there are strong twin traditions of curtailing subnational government access to private credit markets and of meeting capital needs through national government grants and concessionary lending programs. The long-term loan capital available for these programs typically is provided by multilateral and bilateral donor organizations through on-lending programs administered by central government agencies and guaranteed by the sovereign. While such competition makes private market development more costly and difficult, subnational governments will need to find a route if they are to meet large and growing needs for capital and to lessen obvious dependencies. Credit assistance to subnational governments covers a wide variety of possible aids, ranging from technical assistance and credit enhancements to specialized intermediaries and direct lending programs. Depending on the creditworthiness and managerial capacity of the subnational government and the nature and depth of the financial markets, each technique has its advantages and drawbacks. A promising technique is the use of a financial intermediary that combines the borrowing of smaller governments into larger issues that afford economies of scale while exposing the underlying borrowers to market-oriented requirements. Another is the use of credit enhancements to offer assurance to lenders while schooling borrowers in ways to improve their credit stature.

A major challenge in programs that directly extend credit is the need to avoid making subnational borrowers captives of such programs and to encourage borrowing in domestic markets where possible. Part of the solution is to integrate grant and lending programs in ways that not only encourage but also reward governments for achieving credit market access. Chapter 11 reflects on ways to extend the maturity of debt in markets that are unwilling or unable to lend for the long term.

Part 5. Policy Guidelines

Chapter 13 provides policy guidance based on experience, both good and bad, with subnational credit markets:

- While there may be no one "right way" of developing subnational credit markets (due to the enormous variety of circumstances and structures), there are ways of achieving that end where it is both desired and possible.
- Subnational borrowing appears to have clear positive effects on credit markets. While accessing credit markets imposes burdens and risks, exposure of subnational governments to the market's appraisal of transactions, demands for information, and requirements for budgetary discipline is beneficial and is an important component of responsible self-governance. While not all political and economic systems are capable of supporting a market for subnational debt, emulating the required behavior and laying the foundations for a market flowering when conditions permit are worthwhile activities.
- Weak, unstable, and corrupt central governments undermine the ability of subnational governments to achieve good credit ratings and the ability of financial markets to function fairly and efficiently. Instability in international financial markets renders them an unreliable, "fair-weather" source of funds, at least in the near term. Thus building viable domestic financial markets is an immediate task—one to which subnational governments may contribute if they are fiscally stable.
- Subnational governments could be given broader powers, the more open and competitive the financial markets they are to enter and the more stable their fiscal circumstances. Regulatory schemes for subnational borrowing need to have prudential limits that are clearly stated, well-monitored, and enforceable. Good information systems are key components of success.

- In line with the development of markets, subnational governments need a clearly stated range of types of security they can pledge. Intergovernmental transfers and shared taxes often predominate as sources of funds. Especially in fiscal systems that want subnational self-determination as well as the economies of central collection of revenues, the ability to use and pledge these funds is vital to providing adequate security to investors. Where all subnational revenues are consumed by expenditures for vital services, subnational governments should not be borrowing.
- Information and subnational accountability are key factors in the effective operation of markets. Assessment of risk, crucial for determining the cost of capital, requires reliable, complete, and timely information. Subnational governments need to develop the capacity to report and manage their affairs in plain view. Without the discipline of the hard budget constraint, markets have little reason to distinguish among credits, and the rationale for market allocation of resources is lost.
- Credit assistance should be used surgically, with supporting efforts to build subnational skills to make financial decisions. Credit assistance should help subnational governments tap into private credit markets. The integration of grants and concessional lending, with access to conventional markets essential to avoid undermining conventional markets. For small borrowers and shallow markets, either bank-centered or specialized lending intermediaries hold promise as ways to take advantage of economies of scale while preserving market-driven behavior and constraints.

Part 6. Country Case Studies

Part 6 consists of 18 country studies on subnational borrowing. The studies vary in approach, but the shared objective is to examine recent experience with subnational borrowing and to assess what has worked and what has not and the reasons for the successes and failures. The studies illustrate the wide range of government and market settings.

Latin America and the Caribbean

Latin America has the highest volume of subnational borrowing in private markets of developing regions, but with borrowing highly concentrated among large provinces and major cities. Much of the credit has been used to fund accumulated operating deficits. Through the years, huge central government bailouts were engineered to avoid the collapse of the debtor governments. Accumulated debt reached such great proportions in Argentina and Brazil, as it had in Mexico before them, that its continued financing has been a major source of economic destabilization.

Argentina and Brazil both had some early success in the sale of subnational debt in the emerging international bond markets. However, recent defaults have largely closed these markets to them. The excesses by a few large borrowers have precluded many smaller ones from enjoying market access, as national governments tightened the regulatory leash. A legacy of bad debt behavior continues to plague the weakened domestic markets.

In contrast to Argentina and Brazil, Colombia essentially used a market-based mechanism to impose limits on local borrowing, allowing it to continue in a controlled environment. Colombia made a significant shift—though with restrictions—toward decentralization in the 1990s. Initially, borrowing restrictions were lax because of legislated mandates to increase central transfers, and subnational borrowing doubled relative to GDP. The transfers contributed to growing fiscal deficits of the central government. In 2001 the central government implemented new laws to streamline the intergovernmental transfer regime and free up extra revenues to address imbalances. The new laws require approval from the Ministry of Finance for additional debt and link borrowing controls to the fiscal health of local governments. Thus strong central control curbed an earlier acceleration in subnational borrowing. Surprisingly, continuing deficiencies in the regulatory framework have not led to widespread fiscal difficulties, though decentralization and mandated spending have continued to strain fiscal balances.

Mexico, meanwhile, has taken a bold initiative to resurrect its previously troubled subnational borrowing by requiring that bank loans and bond issues be rated by internationally recognized rating agencies. All these countries have large vertical imbalances, with subnational governments highly dependent on central government collection and transfer of revenues. However, even among the wreckage of the Argentine system, some positive lessons have emerged on the use of trustees and the structuring of loans to lessen the risk of devaluation.

Sub-Saharan Africa

Sub-Saharan Africa exhibits great contrasts in subnational government borrowing, with major challenges for the future. Both South Africa and Zimbabwe have had relatively sophisticated financial systems and active municipal bond markets.

In South Africa prior to 1994 municipal borrowing was largely limited to relatively well-off, historically "white" municipalities and was effectively underwritten by central government. From the late 1990s to the present the central government has undertaken a large number of structural, institutional, and policy reforms in subnational government. The ongoing change and uncertainty this introduced into the municipal sector, coupled with ongoing problems of budgetary and financial management in many subnational governments, have created a climate in which municipal lending has stagnated. Notwithstanding the success of certain private sector initiatives targeted at improving access to the markets (in particular, the Infrastructure Finance Corporation of South Africa), private sector lending to municipalities has declined while public sector lending has expanded. As of mid-2003, with crucial aspects of the legal and regulatory framework governing municipal finances and municipal borrowing still to be enacted, the future of the private municipal debt market—both direct bond financing and intermediated debt—remains unclear. This lack of clarity exists despite the sophistication and liquidity of South Africa's capital markets and significant potential demand from subnational governments that badly need funds for investment in local infrastructure.

Zimbabwe illustrates a situation in which a small municipal credit market was created and sustained artificially for many years by central government policies that favored—even compelled—institutional investment in subnational lending and, accordingly, entrenched moral hazard, with predictable results. The policy issues surrounding this market and attempts to reform it have been dwarfed by the impact of the larger political and economic crisis that has consumed Zimbabwe for the last few years. Until this nationwide crisis is resolved, it is most unlikely that borrowing will become an effective, accessible form of financing for subnational authorities in Zimbabwe or that any initiative to modernize subnational borrowing practices will have a reasonable chance of success.

Middle East and North Africa

North Africa, as represented in the Tunisia and Morocco case studies, presents a different approach to the issues of subnational credit markets. Both countries have continued in a highly centralized political system where subnational financial markets and subnational governments are only slowly gathering new powers. With limited banking systems and nascent financial markets, the focus has been on onlending activities, financed by donor loan programs. Meanwhile, most major infrastructure spending remains a central government responsibility, and subnational capital needs tend to be for small projects. The institutional framework needed to make subnational credit market access a reality remains to be developed. The next stage of development has been to propose the use of financial intermediaries that would access markets on behalf of smaller subnational governments. In this case, the specialized lending institution would play a twin development role: instilling more fiscal discipline and accountability in subnational governments while providing a new investment outlet for markets.

Asia

Asian nations that are emerging from highly centralized government structures reflect very different stages of economic development.

China, Indonesia, the Republic of Korea, and the Philippines have diverse experiences with subnational borrowing.

The People's Republic of China presents something of an enigma: a highly centralized state that is loosely organized, with extreme variations in subnational fiscal capacity and high levels of investment by companies owned by subnational governments that themselves cannot borrow. Although China is a unitary state, it has devolved a great deal of spending responsibility to its subnational units, which are both legion in number and, at the provincial level, as large in population as many countries. While the subnational governments are precluded from borrowing directly using their own credits, they effectively borrow through special-purpose vehicles, which are wholly owned companies that have their own revenues and often supply infrastructure needs on a quasi-commercial basis. Rationalizing the activities of these "off–balance sheet" borrowers, which often have to rely on borrowing from state-owned banks, is a major challenge the country faces as it carefully enters into a regime of financial markets—and the world's financial markets.

Before the financial crisis of 1997 Indonesia had embarked on a plan to offer local water utility and housing bonds in its small but relatively active domestic bond market. Following the East Asia financial crisis, the government structure has undergone radical reform, and a rapid and pervasive devolution of government power is under way. Indonesia's difficult economic conditions, a beleaguered banking system, and political turbulence have delayed resumption of efforts to steer subnational governments toward credit markets. While access is being contemplated, many subnational governments have defaulted on outstanding loans from the national development fund, and all subnational borrowing has ceased. Resolution of defaults and restoration of domestic financial markets are needed before subnational borrowing resumes. How that borrowing should be accomplished within the new political framework is a topic of considerable debate.

In the Republic of Korea there has been considerable borrowing by subnational governments, largely steered, if not controlled, by the central government. Subnational governments that conform to a national planning framework are permitted to borrow on favorable terms from national entities. Korea also has employed a form of "forced lending" that requires participation in loans by private firms that undertake certain nationally franchised activities. Borrowing in private financial markets is growing, however, including bond sales. The Korean bond market was badly shaken by the Asian crisis of the late 1990s and has taken time to recover its footing. As it does, subnational borrowers are likely to play an increasing role.

In the Philippines a small but active municipal bond market operates alongside a subnational credit system dominated by two government-owned banks and two municipal development funds. Recovering from a period of massive defaults that followed the Marcos regime, subnational governments have proved the most creditworthy borrowers in the Philippine economy, thanks to the large and steady transfers from the central government and the ability of state-owned institutions to intercept the transfers. A specialized bond insurance company was formed to increase subnational government access to private capital markets, and all recent municipal bond issues have used its coverage to enhance creditworthiness. Meanwhile, government financial institutions, while still benefiting from mandates that subnational governments use them as depositories, see their dominance challenged.

South Asia

India's federal system has undergone decentralization over the past decade, giving constitutional recognition to subnational governments. The federal relationship between the center and the states has been under stress, with significant vertical imbalances, and subnational governments often find themselves without resources. Nonetheless, there has been progress toward a more market-oriented subnational government borrowing regime. A municipal bond market has emerged, and concessionary development fund loans have been revamped to reflect market conditions and discipline. Tamil Nadu has converted its development fund from a state-administered loan fund to a public-private fund. Acting as an intermediary, this hybrid fund raises capital in domestic financial markets and complements its lending activities with technical assistance.

Europe and Central Asia

The transitional economies of Europe and Central Asia have addressed subnational government credit market access in a variety of ways, with several false starts and changes along the way.

Bulgaria's experience is representative of the more slowly evolving situations of fiscal decentralization found in South-Central Europe (the Balkans). The case study focuses on borrowing undertaken by the city of Sophia, which successfully executed loans in the euromarket and managed to maintain a credible budget under trying circumstances. Other transitional countries, with fewer resources and slower to set aside the old systems, are likely to follow models of bank lending and euro-market access by specialized intermediaries.

The Czech Republic, Hungary, and Poland followed more conservative paths in developing markets for subnational debt and avoided large-scale credit problems at the subnational government level. In each country a few major cities have successfully followed the sovereign government into international bond markets, and a few have entered domestic debt markets. After initial flurries of activity, however, most subnational government credit needs have been met by a combination of bank loans and development funds. Moreover, subnational capital demands have been reduced through tightened legal limitations on borrowing and the availability of receipts from the sale of privatized assets. Growth in subnational government borrowing in credit markets also has been retarded by weak economies, the uncertainties created by the unsteady devolution of fiscal powers to subnational governments, and the reluctance of these governments to borrow. Recently, many of their capital needs have been met by concessional loans and grants. European Union structural funds will make borrowing easier for subnational governments as the inhibiting factors mentioned above lose potency.

There have been several bond sales in these three countries' domestic markets, but the domestic bond markets have been slow to grow. This is due in large part to high interest rates, the small number of long-term investors, and the difficulties of attracting investors to small, soft-currency investments. The markets are generally illiquid, have few participants, and are preoccupied with financing sovereign debt. However, with these countries' pending accession to the European Union, domestic financial markets have begun to reflect the convergence and the broader European securities markets. The amply funded and far-reaching grant and loan activities of the European Bank for Reconstruction and Development now strongly influence the development of subnational government credit as several transitioning countries set their sights on meeting standards required to enter the European Union. While domestic bond markets will serve needs at the margin, the focus appears to be on bank lending and accessing the Eurobond market. As part of the process, it is likely that a role will emerge for specialized lending institutions ("bond banks") that can access euro credit markets to meet the needs of smaller borrowers.

The Russian Federation has had the most dramatic (and chaotic) experience with subnational borrowing, reflecting the fragmentation that occurred after the dissolution of the Soviet Union. In the mid-1990s, Russian regions and major cities issued large amounts of debt in both domestic and international financial markets. Massive defaults of subnational debt followed the 1998 financial crisis, as payments of shared taxes and grants from the central government evaporated and the national government was forced into default and devaluation. However, the two major cities of Moscow and St. Petersburg managed to avoid defaulting on their debts and have continued to enjoy some limited access to much shrunken markets. The case study describes St. Petersburg's struggle to preserve its creditworthiness in the midst of the turbulent conditions at the turn of the twenty-first century.