Chapter 3

Market Setting and Legal Framework

The financial operations of subnational governments are strongly affected by the financial market and the legal framework. The two are intimately linked. For markets to thrive, laws and regulations on their operation and structure should be in place and enforced. Financial markets, dealing in vast amounts of funds with numerous buyers and sellers, are by definition advanced marketplaces that are efficient and ultimately sustainable only to the degree that an equally vast variety of transactions is quickly and honestly handled. Borrowing rests on the premise that funds are lent with the expectation of their repayment and with compensation for their use. The debt instrument is a contract to that effect. The capacity of subnational governments to access credit markets, by bank loan or bond issue, depends on the perception of their debt contracts as a strong promise to pay so that funds can be secured on favorable terms.

Financial Market Structures and Subnational Finance

Credit market access for subnational governments is strongly tied to the character and stage of development of domestic financial markets.[1] While financial markets vary greatly, some generalizations seem to apply. In growing market systems, liberalization of capital markets and greater devolution have tended to go hand in hand, although not always at the same pace. These are difficult transformations, still under way.

Stages of Development

Domestic financial sectors are undeveloped in most emerging economies, with limited formal financial market activity and few institutions to supply credit and mobilize savings. The size and vigor of financial markets are typ-

ically considered a leading index of economic development. Most studies have concluded that economic progress is closely allied to the appearance of private sector financial institutions that can marshal resources, accommodate payments, pool risks, allocate credit and make equity investments, and monitor borrowers and ownership interests (World Bank 2002c). However, many important provisos arise. For example, to operate well financial markets require strong supporting institutions. To meet these conditions, these supporting institutions must often undergo reform themselves.

Most reformers agree on what the destination should look like, that is free markets working efficiently within an acceptable framework of social justice. Agreement on how to achieve the goal within the boundaries of acceptable short-term costs is more elusive. Some would have all reforms in place before trusting the market to be an efficient allocator. Others believe that experience is the best teacher and that a better course is making incremental reforms to meet needs as they arise.

Most emerging and transitioning economies are notable for the low level of bank deposits and lending relative to their gross domestic product (GDP). Bank lending to the private sector is limited as are investments by other financial institutions, so investment tends to be self-financed from firms' current savings. As an economy develops, there is greater use of external funds, first from banks and later from stock and bond markets; these, in turn, depend on the development of private nonbank financial institutions, including pension funds, insurance companies, mutual funds, and securities markets. The operation of banks and nonbank financial intermediaries depends on the regulatory framework, while the potential size and scope of the financial system depend on the size and vigor of the economy.

The Role of Banks and Securities Markets

Generally, two different "visions" have evolved on the role of the banking sector and nonbank financial institutions in the provision of capital. Banks, as suppliers of credit, have dominated most financial systems throughout the world and continue to do so in most developing countries, as well as in Western Europe. In the United States and several other developed countries, however, a broader model of a financial market system dominates, with strong securities markets for active trading of equities and debt among a variety of investors (see box 3.1)

Sometimes, the banking system spurs development of capital markets. In the Philippines, private banks have begun to purchase municipal bonds rather than lend funds to municipalities. Lending to municipalities is dom-

inated by government-owned banks, with close political and financial ties to local politicians and captive deposits of subnational government funds (required by law). Nevertheless, financial and tax incentives and the reasonably developed underwriting infrastructure in the Philippines have created a nascent municipal bond market, actively assisted by international donors (see the Philippines case study, chapter 26).

Debate continues on the advantages and disadvantages of the banking system and securities market approaches for raising capital, but in most countries a mixture has been found to be useful, especially for long-term borrowing.[2] The more important issue appears to be competition: can subnational governments seek capital in credit markets with effective competition among several private sector providers? For small countries with concentrated banking systems and few nonbank institutional investors, the possibilities are remote for domestic financial markets to meet competitive norms.

Another set of concerns is the regulation and optimal structure of financial markets. In most developing and transitioning economies, banks dominate the financial sector, often growing out of a tradition of one or a few government-owned banks that monopolize credit provision. Financial liberalization and the emergence of securities markets as countries move toward greater private ownership and market-based economies tend to begin with the creation of a primitive “money market” (securities markets for short-term debt obligations), soon followed by an equity market and stock exchanges (Schuler, Sheets, and Weig 1998).

The sequence is appropriate. Money markets, frequently narrow in the number of buyers and sellers and focusing on a few frequently traded short-term obligations, have often been the exclusive domain of banks trading overnight funds. A strong banking system is a necessary component of a market-based system. Securities exchanges are important because they offer a mechanism for making longer term debt obligations liquid, but without an efficient banking system and payments mechanism, stock and bond markets are unlikely to survive. The question is whether the money market and the stock market will form the launching platform for a longer-term debt market and if that market will be accessible to subnational governments.

Another feature of many emerging and transitioning economies is the heavy reliance on the banking system to finance central government debt; this reliance can be an impediment to the development of markets for private debt and subsovereign debt (see box 3.2).[3] Sovereign debt, commonly at generous yields, tends to squeeze out available capital for “riskier” pri-

Box 3.1. Banks and Securities Markets: Are Both Needed for Development?

Research indicates that financial structure does not explain cross-country differences in long-term GDP growth, industrial production, use of external funds by firms, or firm growth. However, there is a correlation between the level of a country's wealth on the one hand and development of nonbank financial institutions and the relative size of the securities market on the other.

Financial structure tends to change with development, because banks and securities markets have different requirements for information and contract enforcement. The information that banks collect is private and gathered in their direct relationship with clients, which limits the reliance on outside support services such as accountants or rating agencies. A bank can control a borrower's conduct by threatening to withhold credit or to hold the borrower's deposits, but large financing needs may exceed the resources of individual banks or violate their prudential restrictions. Securities markets depend on bondholder and equity-owner protections, reliable and timely accounting and other information, and external analysis by credit rating agencies and investment funds, among others.

Borrowers will seek access to security markets to increase competition for their investments and to enjoy more options in type of financing. Security markets require both interested investors and a strong support system to protect investor rights and the functioning of markets.

Source: World Bank 2002c.

vate sector loans. It also has lessened the desire of investors to finance subsovereign debt, often viewed as junior in status and, in effect, subordinated to the sovereign debt.

Stock exchanges (often seen as the banner institution of capitalism) have been created in many emerging economies, often as by-products of

Box 3.2. Brazilian Banks' Excessive Concentration in Government Securities

Banks can be exposed to financial turmoil because of banking capital adequacy regulations that foster reliance on the banks' domestic sovereign government obligations. For example, Standard and Poor's downgraded Brazilian Banks in mid-2002, not for weak private loan portfolios but for excessive concentration in central government obligations. These are domestically favored under capital adequacy norms that view them as the most secure uses of capital. They are weighted as "zero risk" under the conventions of the prevailing capital adequacy system and do not require a capital allocation from a regulatory point of view.

However, in the sterner world of international finance, a declining currency and a shaky central government can lead to a downgrading of the banks for reasons that are diametrically opposed to the capital adequacy norm. In Brazil's case there was an across the board downgrading of banks even though the domestic private loan portfolios were judged to be secure because of the weakness of the central government (which sets the upper end of the scale in terms of the sovereign risk limit) and the heavy concentration of the banks in central government bonds, along with the rapid depreciation of the Brazilian real.

Source: Standard & Poor's Research, *Brazilian Banks in Time of Turbulence* (July 24, 2002).

converting government-owned industries into private concerns. An objective has been to stimulate increased private capital formation and to create new sources of investment funds. Credit financing per se and the listing of debt obligations on exchanges have not usually been central features of the new financial systems. Furthermore, in many domestic markets, high inflation rates, unstable economies, bank domination of credit, and evolving legal systems have combined to discourage the use of credit market instruments by private entities.

Both the bank-dominated and market-dominated models have their advocates. Here, the presumption is that as other financial institutions grow in importance, there will be a natural push to develop debt markets as an outlet for their funds and to meet needs for asset-liability matching, diversification, and liquidity. Accordingly, the following chapters pay considerable attention to the creation and operation of bond markets and the groups of "passive" investors that may supply credit by that means.

Experience in Developed Economies

Developed countries have used a variety of borrowing methods, institutions, and debt instruments to finance long-term subnational infrastructure needs, but two forms predominate: government-sponsored financing institutions and bond markets. Specialized lending institutions have been the preferred approach in Western Europe, while direct access to bond markets has been the preferred approach in the United States. Political history and financial circumstance have generally guided the choice of model.

In Europe the unitary state structure, strong state-owned banking systems, and the limited and subordinated role of subnational governments led to the late development of subnational capital financing responsibilities. State-owned banks specializing in extending credit to subnational governments emerged in the early twentieth century in a number of countries. In Austria, Belgium, Germany, Finland, France, Italy, the Netherlands, Spain, and Sweden, these institutions often were financed by special deposits that provided low-cost funds for lending to subnational governments.[4] Sometimes localities formed cooperative financial institutions (as in Finland, the Netherlands, and Sweden) to finance their borrowing needs. For the most part, these institutions amounted to state-sponsored credit monopolies.[5] They became increasingly market-oriented as deregulation enabled them to raise funds by borrowing in capital markets.

In the late 1980s, with the move toward privatization, state-owned specialized banks became candidates for private capitalization. An outstanding example is the transformation of the Credit Locale de France into a private stock company in 1987. No longer a depository institution, Credit Locale became a major bond issuer in the domestic and international markets. Its merger with the Belgian Credit Communal de Belgique led to the formation of Dexia in 1996, a full-service, "relationship" banking institution that makes loans and underwrites subnational government bond issues through its affiliates. Dexia has bought shares in the specialized subnational lending institutions of Austria, Italy, and Spain. It has about a 40 percent share of

the French local government loan market and a 90 percent share of the Belgian market. Dexia seeks long-term relationships with its subnational clients and provides management and planning services in addition to banking services. This model is similar to that of the traditional European bank, which often has close operational relationships with its corporate clients.

The U.S. experience is different. Its federal system has prevented heavy central involvement at the subnational level. State and local governments are responsible for most public works spending and have their own strong revenue systems. With a fragmented banking system and a highly developed capital market, this structure of broad local responsibilities and substantial fiscal capacity encouraged direct borrowing from bond markets, helped by the exemption of interest on state and local bonds from federal and state income taxes.

The U.S. municipal bond market is by far the largest in the world, with some 14,000 new bond and note issues sold each year.[6] As of late 2002 approximately $2 trillion in U.S. municipal bonds was outstanding, an amount equal to all the corporate, financial institution, and government bonds outstanding in emerging markets (IMF 2002, p. 49). Size, wealth, a long tradition of federalism and subnational government autonomy, and strong institutional development combine to make the U.S. experience with subnational direct borrowing in the bond markets unique. Nonetheless, other countries, including those in Europe, have permitted or actively promoted the direct use of bond markets by major subnational issuers.

However, as noted, there is some specialized intermediation activity in U.S. municipal bond markets as well. In 12 states small governments can use bond banks, and many other states have special revolving funds for environmental purposes that were created using special capital grants from the federal government in the early 1980s.[7] In addition to tax exemption of interest income, the U. S. tax code contains provisions for the treatment of bank investments in subnational government obligations that favor borrowing by small governments.[8] Emerging and transitioning economies are applying elements of both the European banking-based and U.S. capital market-based models. In addition, most have looked to donor-assisted loan funds as the principal sources of capital. Operated by national or state government entities, municipal development funds are the sole source of long-term funds in many countries, with interest rates and terms much better than would be otherwise obtainable in domestic capital markets—where these markets exist.

Municipal development funds usually have multiple objectives and may provide training, technical assistance, and grants in addition to loans. The funds have had mixed success. In Brazil state-level municipal funds have had impressive results in working with municipalities (on concessionary terms, however, effectively precluding competition from private market sources). A major issue is how to wean the funds from donor dependence and reshape them to promote more private sector involvement in subnational finance. One fund, the Tamil Nadu Municipal Development Fund in India, has been converted into public-private joint ownership with private sector management. It has sold bonds on the Indian capital market and increasingly acts as an intermediary (see the India case study, chapter 24). Multinational organizations, leery of creating a culture of dependency in credit programs, are seeking ways to leverage more private capital into financing infrastructure.[9]

An Array of Options

Subnational governments have an extensive array of potential domestic sources of credit, from direct loans from agencies of the central government and various state-sponsored specialized loan funds to private capital markets (figure 3.1). What options are actually available to subnational governments depends on various limitations and controls, including laws and regulations, private sector capacity, and market-imposed limitations. For example, subnational governments may be precluded by law or practice from borrowing in the private sector, or they may have nominal access but little interest in their securities.

Most developing and transitioning countries are still emerging from a time when the central government was the exclusive provider of capital funds or took primary responsibility for capital projects. This was the case for the unitary states that emerged from the former communist states and for highly centralized countries elsewhere. Much of the story of improving access to credit markets for these countries is one of moving from a central government monopoly in the provision of credit or in responsibility for capital projects.

The options among sources of funds are not mutually exclusive. Even in relatively undeveloped economies several sources may operate simultaneously. In addition, financial structures are undergoing change. There has been a worldwide move toward privatization of bank ownership. A subnational government that has relied on a government-owned bank for capital might have to find a new source of funds, although in some cases the cred-

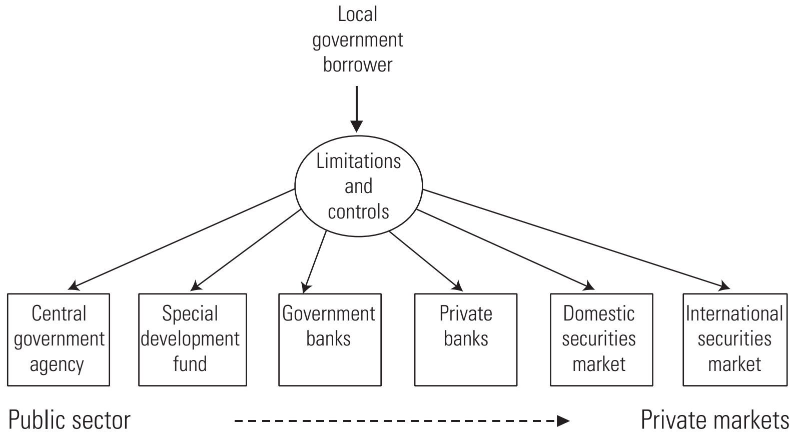

Figure 3.1. Market Structures and Sources of Capital for Local Government Borrowing

it and depository activities of subnational governments are sequestered and retained by government-owned institutions.

Access by subnational governments to international securities markets is still a rare occurrence. Few subnational governments have managed to attract foreign investors; national governments, concerned about the implications for monetary and exchange rate policies, have banned access to international securities markets or have supervised it carefully. For example, after the devaluation of the ruble in 1998 and widespread defaults, the Russian national government forbade new lending in the international markets by subnational authorities (see the Russian Federation case study, chapter 31).

Barriers to the Market

The financial operations of most subnational governments are still highly regulated by the center, effectively precluding or severely limiting private sector interest in their debt. A common restriction is that subnational governments must keep their deposits with the central government treasury or in a government-owned bank (see the South Africa case study, chapter 18). Moreover, the traditional insulation of subnational government from private sector financial institutions has led to mutual ignorance, if not distrust.

Subnational governments may find that accessing private capital sources is uneconomic or politically difficult to justify. This can occur where the central government or its lending institutions provide direct funds on

terms that are much better than those of the private credit markets. A major source of such concessionary loan funds has been donor-based on-lending programs, which offer low rates of interest, generous grace periods, and longer term loans than the private sector can. Even where there is a long wait for the low-cost funds and waiting costs are high, local leaders are reluctant to borrow from higher-cost private sources.

Concessional lending has had mixed results, at best. There have been concerns about the long-term efficiency of channeling capital into low-return public projects and about the incentives that are created for governments in order to qualify for such borrowing. Hence, a special concern in meeting the capital financing needs of subnational governments is to wean them away from concessionary finance and to make them both better able and more willing to compete for funds in commercial markets. Of course, private sources of capital must be willing and able to make such loans. Bringing subnational governments and capital markets to the requisite levels of willingness and ability to receive and make loans and to issue and invest in securities is, as outlined in the following chapters, a great challenge.

The Role of Subnational Government Borrowing in Developing Financial Markets

Subnational obligations ought to be viewed in the context of credit market development. Their contribution to that development, while seldom acknowledged, can be substantial. Even with the tide of devolution, the notion that subnational governments would seek resources from private sources was novel and has taken some getting used to by private market participants.

While the options for credit access differ by country, the transition from central government monopoly to private market competition has tended to move from exclusive reliance on the central government to increasing reliance on the banking system and then finally to access to securities markets (figure 3.2). These sources are not mutually exclusive, and they may be tapped in tandem, with larger borrowers that are better able to compete moving toward the use of the securities markets as they develop. Business firms have followed much the same trajectory. As is the case with private firms, the evolution in credit markets often stops with the banking system, which dominates the financial landscape in many countries. However, in economies that are intent on developing securities markets, subnational governments will eventually either directly enter the securities market or be greatly influenced by it, accessing it indirectly through intermediaries.

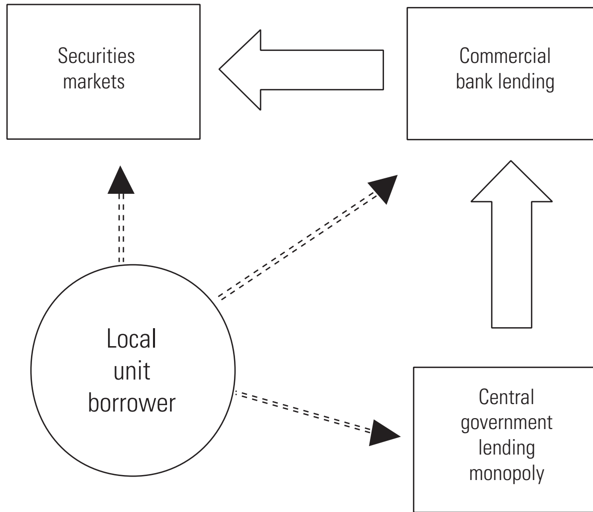

Figure 3.2. Stages of Development in Credit Market Access

The move toward privatization in most developing and emerging economies has left subnational governments in a quandary. The presumption has been that financial markets were a private sector phenomenon and that governments had little to offer in the way of resources or security. Where government activities in the sector were profitable, they were viewed as belonging in the private sector and the solution was to privatize them.

While that thinking continues in many countries, a more balanced appraisal sees the subnational government as a supplier of vital services and critical infrastructure for an improved society and thus as a strong stimulus for the development of capital markets. Good models are provided by Canada, the United States, and a growing number of Western European countries whose subnational governments and their enterprises are often the major providers of public services, using their own resources and making their own investment decisions. Since most such governments are well-run and benefit from their monopoly positions as potential borrowers, investors operating in well-regulated financial systems see the obligations of these governments as safe outlets for their funds.[10] In many emerging economies subnational government obligations can attain a level of creditworthiness that makes them attractive investments for the private sector and for banks, although banks are limited in their ability to provide the

long-term financing needed for infrastructure. Additionally, in some emerging economies subnational governments have already entered securities markets, providing new investment outlets.

The Legal Setting

Underdeveloped legal systems and weak and corrupt judiciaries can make it difficult for subnational governments to convince wary private investors to invest in their obligations. Increasing subnational borrowings in domestic financial markets often requires adjusting regulations on borrowing authority and the issuance, registration, and servicing of debt, as in Morocco, for example. Market distortions that lead to a preference for one instrument over another (loans rather than bonds, for example) need to be removed. The regulatory and supervisory framework for subnational borrowing needs to be strengthened, especially prudential regulations and bankruptcy laws (see the Morocco case study, chapter 20).

Institutions and large individual investors are interested in knowing that the obligations in which they invest are valid obligations that create enforceable claims against the obligors, based on underlying contracts. Contracts and their enforceability vary according to the legal system under which they are drafted and the transparency, competence, and honesty of the judicial system that enforces them. These attributes of legality and enforceability of contracts, basic to the fair and efficient operation of capital markets, are often undeveloped and weak in developing and transitioning economies.

Differences in Legal Systems

Legal traditions have had a profound influence on fundamental concepts of ownership and creditor rights and consequently on the development of financial markets. There are wide differences in how quickly and how well laws pertaining to investor and creditor rights are enforced. These rights are not inherent in the securities but are determined by law. This can have a profound effect on the ability of countries to establish effective securities markets for debt and equity capital.[11] Laws governing financial markets and securities strongly influence the accessibility and cost of capital for subnational governments.

Security—what the lender can look to for assurance that a loan will be repaid or, if not, what asset it will be able to seize—is a fundamental concept in private capital markets. Numerous complications can arise. Some le-

gal systems are weak in describing creditors' legal rights: the priority of creditors' claims may be unclear, the legal presumption may run to the party that has physical possession and use of the asset, no matter the liens against it. Laws governing secured transactions may be in conflict or may predate modern commerce and financial relationships and instruments. Thus laws may limit who can lend, what types of collateral may be pledged, and how the collateral is to be identified and physically kept. However, even where the ability to use collateral as security is clear, there may be no central registry to keep track of liens against collateral. The ability to collateralize a right to revenues (and assign them, as in the case of tax collections) may be ambiguous or nonexistent (World Bank 2002c).

The local financial obligations of some Czech municipalities are guaranteed by national institutions, but most are not explicitly guaranteed and it is unclear how creditors would recover their money in case of default. The Czech Bankruptcy and Composition Act does not cover municipalities, an omission believed to contribute to the reluctance of the banking system to finance municipalities. Municipalities, for their part, have been granting loans and guarantees to businesses to support local development activities. Although these financial activities require the approval of municipal assemblies, the procedures to be followed are not clear. The lack of debt monitoring and supervisory mechanisms softens local budget constraints and creates moral hazard incentives, contributing to higher fiscal risk (see Czech Republic case study, chapter 28).

In addition to the complexities of pledging properties and gaining rights to revenues, a lender's willingness to accept pledges depends on enforcement and the ease with which claims can be settled. When the ability to enforce pledges surely and quickly is in doubt, loans are not forthcoming or are forthcoming only at higher rates. While enforcement problems are acute for loans to private parties in the case of moveable property, they are exacerbated in loans to the public sector by restrictions on pledges of public property and the difficulties in enforcing such pledges against the sovereign or its subdivisions.

A practical problem is the independence of the judiciary and its competence to understand financial issues and adjudicate impartially. Modern securities markets depend on concepts that may exceed the mastery of traditional judges. They also depend heavily on the integrity of a system of laws rather than on traditional or political relationships. An "absentee creditor" many miles removed from the scene who relies on a written contract is unlikely to obtain justice in settings with a corrupt or weak judiciary.

Implications of the Legal System for Subnational Borrowing

Subnational government borrowing is part of a larger legal fabric that sets the roles and responsibilities of public and private sector entities in the operation of a subnational government credit market. Several policy issues that have a substantial impact on subnational government borrowing can be covered only tangentially in this book. Examples are policies and practices on ownership of public property and property rights associated with such ownership, the structure of intergovernmental revenue sharing, the adequacy and reliability of the accounting standards, regulation of the banking system and other financial sectors, and judicial enforcement.[12]

Nonetheless, an imperfect legal system and evolving fiscal situation are not necessarily impediments to the initial development of a subnational government credit market. Many countries have had imperfect legal structures when they began pilot projects in market-based subnational government borrowing. Some now have developed substantial subnational government credit markets. Many of the risks can be diminished through provisions in the loan contracts, even before a fully developed legal framework is in place. In fact, the practical problems of developing "pioneer" transactions have exposed gaps in law and practices and prompted solutions.

Both policy reforms and market practices are likely to be implemented incrementally. A successful subnational government credit market must be built both from the top down, by building a legal and policy framework to support efficient credit market operations, and from the bottom up, by accumulating practical experience in banks and other lenders in making loans and in subnational governments in borrowing to finance high priority investments and making timely debt service payments. Both tracks should move forward simultaneously.

Legal Framework—Planning Ahead

Several emerging and transitioning countries have confronted the reality of large-scale subnational government borrowing and been obliged to construct a legal framework after the fact to accommodate the interests of stakeholders on both sides of the market. Developing subnational markets can benefit from examining the difficulties in countries where subnational borrowing got out of hand. From Brazil to Russia excessive borrowing by some subnational governments in the absence of an adequate legal framework has exacerbated national economic crises. The promise of soundly based subnational borrowing is large, but the risks in badly prepared borrowing are also large. All parties (subnational governments, banks, and po-

tential investors) share an interest in fully understanding the policy issues surrounding credit market development and in having an appropriate legal framework in place before substantial borrowing occurs.

Notes

1. The term *financial market* is used generically and encompasses both bank and non-bank institutions and other potential providers of capital, including various governmental entities that may lend to subnational governments. Although governments themselves are not participants in the equity markets, their companies and projects can be from time to time, and since stock exchanges frequently deal in both equities and debt, their existence and activity are of interest here. The term *credit* is also used generically to describe debt obligations and not just bank loans.

2. The crux of the matter is finding a financial structure that suits the needs of investors and potential borrowers. To finance infrastructure, local governments need access to long-term capital. On the investors' side, there are institutions and individuals that prefer long-term investments to offset their long-term liabilities. Banks, on the other hand, are constrained by the mismatch between their short-term liabilities (deposits) and the long-term assets that loans for infrastructure represent. Another desirable attribute of the securities market is the need for disclosure and the collateral benefits of wide scale information about the financial conduct of governments.

3. To the extent that a market for debt securities existed at all, it was dominated by central government or central bank obligations. Frequently, the debt market existed primarily if not exclusively to finance central government deficits. Regulation of investments and bank assets is tilted toward providing a ready market for the national government debt. The extension of credit to private entities often has taken a back seat in banking operations.

4. Except for Finland, the Netherlands, and Sweden, all the specialized banks have been privatized. For a discussion of national experiences with specialized municipal lending institutions, see Peterson 1998.

5. Japan, as a unitary state with close fiscal linkages between the central and local governments, has followed a similar pattern. About 75 percent of its local government financing needs are met by specialized central government-owned entities. Low-cost funds are available from the Fiscal Investment and Loan Program, financed indirectly by Post Office savings accounts. The other 25 percent is made up of direct borrowings from private sector institutions or bond issues. Subnational borrowings need the ap-

proval of the central government. See Mihajek, p. 297. Lending to local governments is treated as part of the counter-cyclical policy in Japan and terms are made easier at times when the national government is seeking to stimulate the economy.

6. The term *municipal bond* is used generically to mean the obligations of subnational governments.

7. State revolving funds were set up as loan funds to replace the federal direct grant program for water pollution control. Some revolving funds employ interest rate subsidies. Some also leverage borrowed funds on top of the capitalization supplied by the federal government and the 80 percent match required of the states.

8. Section 265 of the tax code permits commercial banks to partially write off the cost of capital for holdings on bonds that are sold by issuers that borrow less than 10 million dollars in a given year. The upshot is that interest rates on these bonds are usually 15 to 25 basis points lower than those on similar bonds sold by larger governmental units.

9. Chapter 12 addresses these issues of design in greater detail. The World Bank has recently emphasized the need to move municipal development funds toward "market" behavior; see, for example, World Bank 2001, p. 49.

10. These well-deserved reputations were not built overnight or without disappointments along the way. The United States, in particular, had a long and lurid history of defaults in the nineteenth century that gave rise to restrictions (imposed by the states upon themselves) and hard-nosed market practices (imposed by lenders). These reforms ultimately laid the foundation for subnational bond markets viewed as being the safest next to that of sovereign bond markets. Bank regulation of investment requirements and required documentation, the large size and sophistication of the market, and the strength of the underlying revenue systems all contributed to the development of the quality of the market.

11. Several studies have examined the impact of the legal system on the development of the financial markets. The general conclusion is that of the four "families" of law, countries employing the French civil law tradition have the weakest protection for investors (and creditors) whereas those that follow the common law (British) tradition have the strongest. The other two families of laws, the German and Scandinavian, fall in between. Furthermore, enforcement is often slow and subject to corruption. Regions (such as South America and parts of Africa and Europe) that follow the French civil law frequently provide an unattractive legal environment for

investors, often with high concentrations of financial markets and ownership of assets (see Burke and Perry 1998, chapter 4).

12. Additionally, laws relating to public procurement, tariff setting, and own-source revenues can have a substantial impact on the development of a subnational credit market. Stability and clarity in the generic laws and the ability to specify and monitor conduct in the loan contract are key ingredients to limited obligation "project" financing.