Part II

Borrowing Instruments and Restrictions on Their Use

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Chapter 4

Subnational Governments as Borrowers

Subnational debt can be the obligation of a local, regional, provincial, or state government or of projects they sponsor through subsidies, partnerships, or concessions with the private sector. Subnational governments enter into many types of legal and financial relationships, which can differ markedly among countries. In many places these relationships are evolving, and even where they are established, they continue to be dynamic. Thus, policymakers and analysts must be prepared to examine a variety of factors and risk exposures when dealing with the debt transactions of subnational governments.

Subnational government borrowers have much in common with other borrowers such as public utilities and private firms. But there are also some special features relating to the powers, structure, and operation of subnational governments. For example, most subnational governments deal exclusively in domestic currency for revenues and expenditures. Thus, except for certain types of facilities (electric power, ports, airports, telecommunications), they have little access to foreign currency payments. For some services, governments have powers approaching monopoly status that may be enforced by regulation. Additionally, governments are site-specific and unable to change the geographic locus of business or the fundamental nature of the services they provide. They rarely go out of business.[1]

Debt Classification

A fundamental distinction in classifying debt is whether the subnational government is the borrower, relying primarily on its taxing power and other general governmental revenues to back the loan, or whether the government is just a party to the loan, as when the obligation is limited to a par-

ticular revenue source of an enterprise to which the general governmental credit is not pledged (a limited or nonguaranteed obligation). This distinction is reasonably clear in the United States, where a revenue-generating project or enterprise that is financed with a limited obligation is referred to as a *revenue bond*.

Elsewhere, the distinctions between general and limited pledges can be blurry, as in the case of projects financed with a mixture of public and private funds, service and off-take contracts, profit-sharing arrangements, or concessions with guarantees of use. Confusion is especially likely in countries where various government commercial and industrial activities are being privatized. The credit structure may be especially complex, with a blend of risk factors involving both the public and private sectors, in "project finance" cases, where the private sector is not only a direct investor in a project but also an equity provider and actively engaged in operation and management.

The following discussion and accompanying figures describe three prototypical financing and credit structures involving subnational governments. For ease of exposition, the borrowing is assumed to involve a project, as is typically the case, although it could as well be used for other purposes, including relending, to meet emergency needs or to fund accumulated deficits.

General Government Obligation

With a general government obligation the government uses its general revenues to make debt service payments and owns and operates the project itself (figure 4.1). In most countries this would be the likely structure for capital expenditures for public safety, public education, health and welfare, and similar activities that are not revenue producing. The government issues the debt in its own name and pledges its general revenues. However, neither the financed project nor its earnings are specifically tied to repayment of the debt. In an important variant on this theme, the subnational government receives intergovernmental assistance, such as shared taxes or grants, that is pledged as part of the security.

Government Limited Obligation (revenue obligation)

In a government limited obligation, the debt is secured primarily or exclusively on the earnings of a project enterprise that produces revenues through charges and fees that are used to defray much or all of the costs of operation and debt service (figure 4.2). General revenues of the government are typi-

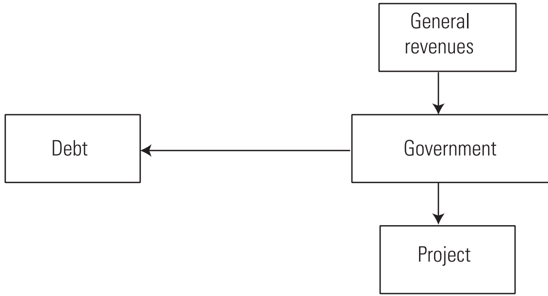

Figure 4.1. General Government Obligation

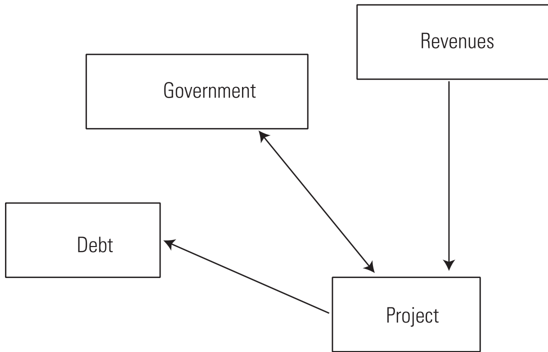

Figure 4.2. Government Limited Obligation

cally not pledged directly, and there may even be a prohibition against their use. Common subnational enterprises are public utilities, such as water and sewer, electric distribution, local toll facilities, public markets, harvest processing facilities, and local ports and terminals. The debt is issued either by the project itself, which may be a limited-purpose special district, or on behalf of the project by the general government sponsor.

Project Financings (public-private undertakings)

In public-private undertakings, typically in utility-type projects, the government contracts with the private sector, through concessions or partnership agreements, to build, own, or operate the project (figure 4.3). The government may contribute in various ways to the financing, including equity

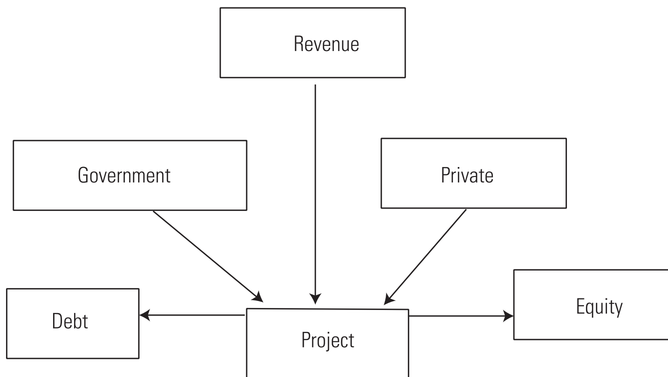

Figure 4.3. Public-Private Project Financing

interests, subsidies, and guarantees related to the demand for outputs or for supplying needed inputs. The private sector, or international lending entities, also may contribute debt, equity, and various enhancements to the financial mix. The contract sets outs the obligations of the respective parties and the returns to each. The debt is typically issued in the name of the project and may be non-recourse, looking only to project earnings, ownership, or assets for security.

Classifying Potential Subnational Borrowers

Many subnational governments already have access to credit through government-sponsored lending programs, bank lending, or sales of bonds in domestic or international capital markets. However, many more do not, and many factors influence whether and how they will gain access.

Classification Based on Fiscal Capacity and Financial Acumen

The fiscal capacity and financial acumen of subnational jurisdictions, which relate to the ability and willingness to pay, are fundamental considerations in determining which units are candidates for borrowing. Although these are not always correlated with size, private creditors generally prefer larger jurisdictions because of their greater sophistication, ability to draw on more resources, and ability to spread the fixed costs of debt transactions over larger volumes of borrowing. In most countries three groups of jurisdictions can be identified in terms of the likelihood for the issuance of subsovereign debt in private markets:[2]

- Those that already have access to capital markets because of their size, financial and managerial resources, and political clout. This group includes the largest and best known subnational governments with large economies and political muscle.
- Those with limited or no access to capital markets but that can generate adequate revenues to meet their responsibilities and otherwise are capable of borrowing private capital. This group consists of subnational governments that are large and capable of attracting private interest without direct central government help and those that are too small or that lack the managerial capability to attract private lending but that could gain access with assistance. One approach is to combine the needs and resources of individual governments and borrow as part of this larger group.
- Those that cannot generate sufficient revenue to provide the current services they require or to build and operate the needed infrastructure. Jurisdictions in this group, which for all practical purposes are "financial wards" of higher levels of government, do not have access to capital markets and most likely should not.

Jurisdictions in the first two groups have the potential to use private credit resources under a regime in which central government assistance to municipal market development, if any, is accommodative and indirect, focused on laws and regulations that create an enabling environment for subnational government borrowing in credit markets. Subnational governments in the third group, the very small and poor, neither can nor should borrow in private credit markets.

As handy as the above triage of candidates for borrowing might appear to be, it is one that defies drawing strict lines of demarcation in practice. Advocates of light-handed intervention and believers in market solutions say that the market itself will define, better than government regulation, which jurisdictions fall into which category. Others argue that markets assume a symmetry of skill and information between buyer and seller that is not met in the case of subnational governments, especially those that are smaller and unsophisticated. Left untended, the unwary can wander into the credit market with unfortunate results.

Like any classification scheme, this one is situational and dynamic. Some governments that are too small and too poor to gain access to credit markets using their general revenue funds may latch on to a project financing scheme that is creditworthy. Even subnational governments with otherwise

insufficient own-source revenues might qualify for private credit if they can pledge a share of their intergovernmental transfers to secure the debt.

Policies to Improve the Creditworthiness of Subnational Governments

Government policies on intergovernmental finance and technical and credit assistance to small and unsophisticated jurisdictions affect how markets assess creditworthiness. It is likely that countries with weakly financed and poorly managed subnational governments will have to forgo direct entry into private credit markets or will need to devise policies to help subnational governments advance up the creditworthiness ladder.

To promote subnational government access to private markets, the Philippines has used a four-quadrant strategy that considers two primary dimensions: a subnational government's wealth and the revenue-generating potential of the proposed improvement (figure 4.4). For the smallest and poorest subnational governments that need to finance non-revenue-producing facilities, grants are the preferred means of assistance (lower-left quadrant). For subnational governments with adequate wealth and self-supporting projects, access to bond markets was the preferred financing mechanism for larger projects, with commercial bank lending at commercial rates with no grants or subsidies for smaller but commercially viable projects (upper-right quadrant). Because bank lending to subnational governments has been dominated by government financial institutions, an added dimension of the approach is to move from government financial

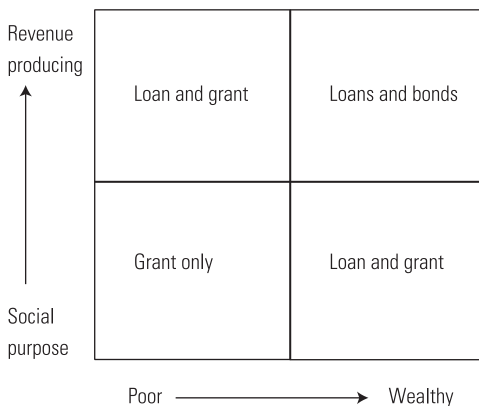

Figure 4.4. Matrix of Subnational Government Financing Capacity

institution lending (the loan and grant quadrant) to private credit sources (the loans and bonds quadrant).[3] Government financial institutions were to facilitate the move to private capital as governments grew stronger and projects became self-financing (see the Philippines case study, chapter 26).

Distinctions among Subnational Jurisdictions

Approaches like these based on existing creditworthiness are useful for analytic purposes, such as describing potential demand for credit and the likely size and viability of a subnational government securities market. However, should such distinctions be codified into law or regulation to identify which subnational governments can access credit markets? In developed economies credit markets effectively classify borrowers and reflect their credit assessments in the prices (interest rates) charged for borrowing, based on perceived differences in economic vitality, managerial efficiencies, financial condition, political sway, and the viability of individual projects.

While detailed regulatory prescriptions are best avoided, senior levels of government have a legitimate interest in the financial market behavior of subnational governments, as chapter 2 describes. Even in mature markets, most national governments and some state governments employ regulatory classification systems to guard against imprudent behavior (see box 4.1). These classifications differentiate among jurisdictions in allowable maximum outstanding debt or, more typically, the maximum debt outstanding in relation to some revenue source, such as a property tax. In the United States most state governments differentiate among subnational governments through legal classifications that can include differential borrowing authority. However, in subsovereign financial systems being put into place for the first time or being radically redesigned, classifications may be overused, poorly designed, or unenforceable. The strongest argument against rigid regulatory classification is that upward mobility in classifications of financial strength and managerial maturity should be encouraged. Classifying a jurisdiction in a way that encourages it to depend on external assistance and avoid responsible borrowing on its own is exactly the opposite effect that government intends to have. Artificially limiting market access runs counter to the basic policy goal of pursuing greater private sector investment.

Subnational Borrowers by Type of Entity

Subnational debt also may be incurred by municipal enterprises and quasi-municipal entities created by agreement of existing municipalities or by

Box 4.1. Defining and Controlling Public Debt

How public debt is defined can determine the boundaries of subnational government borrowing. EU legislation, which limits public indebtedness under the deficit and debt limits of the Maastricht Treaty, defines public debt as the debt of the central, regional, and local governments, including social security funds but excluding the debt of public enterprises. The limitation thus is expressed in terms of the institutional units producing non-market services as their main activity rather than in terms of ownership of the facility. A concern has been how to coordinate debt at the subsovereign level with that at the sovereign level.

Subnational governments have an incentive to place as much of their debt as possible on a self-supporting, commercial basis to avoid macro-level curbs on borrowing. Evidently, however, the EU definitions also include certain contingent obligations that subnational governments might enter into in support of commercial debt, such as obligations to purchase a commodity or service (an off-take guarantee) and pledges to make up project operating deficits or debt service deficiencies from general funds.

The curbs on general obligation tax-supported debt embodied in the EU limits are akin to the individual state-based limitations of tax-supported debt that arose in the United States. In the United States the restrictions on general debt hastened the rise of the non-recourse revenue-bond obligation that is used for enterprise activities and other forms of non-recourse obligations such as the moral obligation bond. These limited obligations, many of which are de facto supported by taxes and fees raised by the general government, once represented only a small fraction of municipal borrowing. They now typically make up 60 to 70 percent of all bonds sold in the United States.

One application of special districts is in the use of business improvement districts. These special taxing units levy a tax in addition to the normal taxes and have the powers and personnel to address the special needs of downtown areas, especially distressed areas, including extraordinary sanitation and public safety needs. The concept has caught on in parts of Europe and may be spreading to developing economies as well.

Source: Petersen and Crihfield 2000.

national or regional legislation. These special-purpose arrangements are of four types:

- Separate restricted funds, accounting arrangements, or special-purpose entities within a municipality, the revenues and expenditures of which are restricted to specific purposes and are separated from the general fund. These entities typically derive their power from the municipalities, although they may have considerable independence.
- Entities created by agreement among municipalities to accomplish a special purpose, such as to provide fire protection across a broad area. Their revenues and expenditures can be separated from those of the organizing municipalities. Their powers can derive solely from the municipalities ("joint powers") or through state or national legislation that limits or extends such combining powers.
- Quasi-municipal entities created by state or national legislation to provide municipal services (such as water development, disease control, or transport services) where needs do not necessarily relate to municipal boundaries. Their powers would be described in authorizing legislation.
- Public-private arrangements, such as project financing, where governments and private sector entities share in the ownership of projects that usually are built and operated by the private sector partner. These arrangements have been heavily advocated by reformers as a way to re-capitalize projects and make enterprises, particularly public utilities, more efficient.

In theory, such special-purpose subnational governmental entities might issue limited obligation debt based on their own revenue sources and the ability to borrow against them. In practice, however, issues are more complicated.

As might be expected, there are two sides to the special-purpose, special-entity borrowing coin. Establishing such entities can allow services to be delivered by an appropriate entity with targeted taxes, fees, and charges. That characteristic is appealing to those that favor an application of the benefit principle and rational pricing of services. Moreover, since geographic areas of traditional general governments have typically inherited a political and economic logic that may be long out of date, the case for promoting special service districts along the lines of economic service areas is often compelling. On the negative side is the possibility of a proliferation and fragmentation of local government and of diffusion of local revenue

sources. There are also questions of the nature of the relationship between the governmental parents and their special-purpose children, a relationship that may rely on subsidies and guarantees, stated or implied, and the exposures that accompany them.

These issues are illustrated in the case of the People's Republic of China. 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 frequently 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 (see box 4.2).

The practical implication of this discussion is that subnational government borrowing powers should remain flexible enough to address both common and special infrastructure problems. An example is the special taxing and fee district, which may permit a unit of government to gear its taxing and charging powers to the particular needs of subdivisions, as is the case in the United States. However, care needs to be taken to ensure that the legal and operational arrangements are clearly stated and that dealings are both correct and transparent.

Cooperation among Subnational Governments

For many projects, financing and operation are more efficient when the scale is larger than an individual subnational government. In many cases the desire to provide more local self-determination has led to the establishment of many small governments that are assigned service responsibilities that exceed their fiscal and managerial capabilities and encompass service areas that exceed their geographic boundaries (see box 4.3). Cooperation is imperative if services are to be prepared in a rational way and capable of being financed by users on a local basis.

Box 4.2. China: Off-Budget Finance and the Transmuted Bond

Under the series of changes in the intergovernmental fiscal system that have occurred in China over the past two decades, Chinese localities found it increasingly attractive to hive off many activities into the off-budget category and have them carried on by government-owned entities. Given the austerity in many subnational governments and the changing mechanics of tax-sharing, the local government-owned companies had the appeal of raising their own revenues, being kept away from the formal budget calculations, and being able to pursue activities either not allowed or not financeable by the subnational government itself. While information is incomplete, it appears that such off-budget activity is about equal to that carried on by the regional and local governments on their formal budgets and may represent as much as 20 percent of Chinese GDP.

One appeal of the off-budget financing is the ban against subnational borrowing from nongovernmental sources on the local government's own credit. However, the special-purpose entities that they create and own can borrow. This is especially important in financing infrastructure and has resulted in a phenomenon known as the "transmuted bond." To access credit, a Chinese subnational government will create an economic entity, which has a close, if legally murky, relationship to the parent, to accomplish the financing through the sale of "corporate" bonds. In some cases, such as Quinyang district of Chengdu City, bonds are sold locally to retail investors, although the usual purchasers are banks and investment funds.

The debt of these special purpose vehicles, whose proceeds frequently are re-lent to the government and repaid by governmental funds, is widely understood to be a contingent obligation of the parent government. Because this transmuted debt is not subject to an orderly process of approval (and financial oversight and reporting), and in view of the prohibition against government guarantees, this debt is seen as constituting a substantial risk for both the financial system and for the underlying government debtors.

Source: China case study, chapter 22.

Many countries have achieved this goal through associations of subnational governments. Subnational governments often have legal authority to "collaborate or associate to perform public works"[4] through contractual relationships among participating subnational governments. Even with such legal authority, cooperative projects still need a legal contractual framework to permit subnational governments to work together in a way that enables the jointly created entity to access financing and avoid the inefficiency of separate financing of each government's share of the cost of a joint project.[5]

Box 4.3. Restructuring Subnational Government: From Few to Many (But How Many?)

The path to the democratization of the formerly communist Eastern and Central Europe states has not been easy. Restructuring unitary systems of government to foster more self-governance has led to a proliferation of subnational governments. In Hungary the number of subnational governments doubled after the 1990 reorganization, and the same pattern was seen in the Czech Republic, the Slovak Republic, and Ukraine. Meanwhile, the new units were given extensive service responsibilities unmatched by expanded local revenue-raising powers.

In large part, the difficulty has been in deciding which governing model to follow. After the fall of communism, territorial fragmentation was greatest in the state systems that followed the Napoleonic (or Southern European) system. The central government maintained a strong local presence through the prefecture system of administration and an array of national services reaching down to the local level. A key responsibility of subnational governments was to represent local interests to the central government, which retained the major sources of revenues, doled out grants, and imposed national standards.

An associated difficulty in devolution schemes has been the disregard of the optimal size of government needed to deliver local

services efficiently. Traditional concepts of "community" often led to high levels of government fragmentation. The idea, again, was representing the locality to the center, as opposed to exercising true self-sufficiency.

In the countries following the Northern European model (and Western federated systems), there was greater effort to achieve the optimal subnational government size needed to match assigned service responsibilities and revenues. The central government does not have a presence at the local level, and localities have more responsibility for delivering local services and for deciding what those services should be and how much to spend on them.

Reconciling the two conflicting views of the proper role of subnational governments has been a big source of tension. Efforts by central authorities to promote regional cooperation have often been resisted by new subnational governments that jealously guard their new autonomy and local resources.

Source: Davey and Gabor 1998.

Notes

1. This is not to say it cannot happen. In Poland, the old state's administrative districts (the Voidvoidships) were replaced by a new structure of counties, the Poviat. In other countries, there have been massive reorganizations and amalgamations. However, a new name on the government building is not the same thing as its being abandoned: somebody else picks up the duties and the liabilities.
2. Later, there will be a discussion of concessionary finance and technical assistance. At this stage, the concern is with identifying the likely "potential market" for private sector capital access and under what conditions.
3. It should be noted that sale of bonds by local governments in the Philippines is restricted by law to finance "self-supporting" projects.
4. Fed. LLSG, Article 16, Bosnia and Herzegovina.

5. In Latvia, the Law on Self-Government determines the right of local governments to “cooperate.” However, the legislation does not state that institutions commonly established by self-governments can be juridical persons with their own budget. Thus, there is a question whether the “joint entity” can borrow, which means that each participant has to borrow on its own. This results in an inefficient structure for jointly financed projects.