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Borrowing by Subnational Governments: Issues and Selected International Experiences

by

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Abstract

The paper presents an overview of different approaches to controls on borrowing by regional and local governments in a broad range of industrial and developing countries. Four main approaches are singled out: (a) sole or primary reliance on market discipline; (b) cooperation by different levels of government in the design and implementation of debt controls; (c) rules-based controls; and (d) administrative controls. The paper discusses advantages and disadvantages of each approach, the balance of which may make the approach more or less suitable to a particular country's circumstances at various points in time.

JEL Classification:

H63

1/ This paper draws on as yet unpublished papers prepared by the staff of the Fiscal Affairs Department of the IMF for a planned book on fiscal federalism. Special thanks are due to Jon Craig for his contribution to the analysis of country experiences and for his helpful comments.

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I. Introduction

The last two decades or so have witnessed a widespread increase in the level of the public debt relative to GDP in many industrial, as well as developing countries. In the OECD countries, the average ratio of the gross public debt to GDP has risen, for instance, from just over 40 percent at the end of the seventies to nearly 65 percent in the early nineties. These increases have reflected a combination of factors: continued upward trends in expenditures, especially on civil servants and entitlement programs; the impact of cyclical downturns in economic activity on revenues and on cyclically sensitive items of expenditures (such as unemployment benefits); and rising real interest rates on the public debt.

Concern about these trends has prompted policy makers in many countries--especially but not exclusively in the industrial world--to adopt medium-term programs of fiscal adjustment aimed at reducing their public debt ratios to a specified level over a number of years. For example, the members of the European Union have agreed on the reduction of their public debt ratios to no more than 60 percent 1/ as a precondition for entry into the proposed monetary union, currently scheduled to begin in 1999. Securing sustained and substantial reduction of public debt ratios will require, in turn, the achievement of sizable primary surpluses in the operations of the general government. These surpluses will need to be larger the greater the

1/ It is, however, understood that for those countries (like Italy, Belgium, Ireland) that have currently debt ratios much in excess of 60 percent, this criterion could be interpreted more flexibly to mean "a sustained and substantial decline of the debt ratio."

gap between the average real interest rate on the public debt and the real rate of growth of GDP.

In many countries, these fiscal adjustment programs will need to be carried out in an environment of growing decentralization of expenditure and revenue-raising responsibilities. This is especially the case, of course, in countries with a federal structure of government, but is increasingly true in unitary states as well, as the worldwide trend towards more democratic and participatory forms of government is being reflected in greater fiscal decentralization.

In a number of countries, both federal and unitary, a structure of intergovernmental fiscal relations leading to large vertical imbalances, and/or the lack of budget discipline by subnational governments have already led to the accumulation of sizable levels of debt by those governments. In these countries, credible programs of fiscal adjustment will need to include a hardening of the budget constraint on the subnational governments, through effective limits and controls on their borrowing. In some cases, a restructuring of existing debts may be required as well. Even countries where the bulk of public debt is concentrated in the central government, strengthened controls on borrowing by subnational governments may be needed to ensure that fiscal retrenchment at the center is not offset by a weakening of the fiscal position of the lower level governments.

Against this background, this paper reviews a broad range of international experiences with controls on borrowing by subnational governments. 1/ This survey shows considerable diversity in approaches to these controls, ranging from virtually sole reliance on market discipline, to direct controls by the central government on individual borrowing operations of subnational government entities. Different approaches reflect, among other things: constitutional provisions; the degree of political and administrative control of the central government over the subnational ones; the country's overall tradition of financial discipline; the presence or absence of serious fiscal and macroeconomic imbalances; and the state of development of the country's financial market. Central government controls over subnational governments' borrowing tend to be looser either in countries with poor overall financial discipline, and as yet unaddressed fiscal and macroeconomic disequilibria, 2/ or in countries with well developed and relatively transparent financial systems, which can rely more on the market to discipline the borrowing of subnational governments.

Broadly speaking, four main approaches can be distinguished, but some countries may utilize techniques of control that span more than one of these approaches:

1. sole or primary reliance on market discipline;

2. cooperation by different levels of government in the design and implementation of debt controls;

1/ The survey covered in particular the experiences of Australia, Brazil, Canada, Denmark, Germany, India, Japan, Korea, Spain, Switzerland, the UK, and the US. Details of these cases will be discussed in an expanded paper on borrowing controls by Teresa Ter-Minassian and Jon Craig for the above mentioned FAD book on fiscal federalism.

2/ This is typically the case in economies in transition, as well as in some developing countries.

3. rules-based controls;

4. administrative controls;

Sections 2-5 of the paper review each of these approaches, in turn, Section 6 puts forward some main conclusions.

II. Reliance on Market Discipline

It has been suggested 1/ that a number of conditions need to be satisfied for financial markets to exert effective discipline on subnational government borrowing:

- markets should be free and open; in particular, there should be no regulations (such as reserve or other portfolio composition requirements) on financial intermediaries which place government in a privileged borrower position;

- adequate information on the borrower's outstanding debt and repayment capacity should be available to potential lenders;

- there should be no perceived chance of bailout of the lenders in the case of impending default; and

- the borrower should have institutional structures which ensure adequate policy responsiveness to market signals before reaching the point of exclusion from new borrowing.

It is clear that these are indeed stringent conditions, which are unlikely to be realized in the majority of countries. Typically, especially in developing countries, available information on the finances of subnational governments suffers from serious weaknesses in coverage, quality

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1/ See T. Lane, "Market Discipline," IMF Staff Papers, March 1993.

and timeliness. Many countries still utilize various forms of portfolio constraints on financial intermediaries, to facilitate the placement of government securities (including local government ones) at a reduced cost. A number of countries also have experienced various forms of intervention by the central government to prevent default by subnational governments on their debts. Finally, and not least importantly, electoral cycles tend to make politicians at the subnational government level short-sighted and unresponsive to early warnings by the financial markets.

Recognition of these realities may be a major reason why sole reliance on market discipline to check subnational government borrowing is not usual. A major industrial country that uses this approach is Canada, at least regarding provincial government borrowing. 1/ To date, the Canadian provinces have no constitutional or legal limits on their borrowing (both domestic and external), and are not subject to central government controls on it. Their debt and debt servicing capacity are closely monitored by financial markets, in particular by major debt rating agencies. A review of the trends in provincial government indebtedness in recent years suggests that, even in a well developed and relatively transparent financial market like the Canadian one, market discipline on subnational government borrowing has not been fully effective. Despite a clear deterioration in ratings, and related sizable increase in risk premiums on provincial bonds--more marked for the more indebted provinces--, provincial debt has shown a steady

1/ Municipalities in most provinces, by contrast, are required to balance their current budgets. Municipal borrowing for investment projects must be approved by the relevant province. Provinces assist municipal borrowing through public financial intermediaries (the municipal finance corporations) and/or through matching grants.

increase over the last several years, and only in the last couple of years have the provincial governments begun to design and implement fiscal retrenchment programs. It may be argued that market discipline is finally starting to work, but only after a "recognition lag" which will necessitate a sharper and more painful retrenchment than would have been necessary if provincial debts, and their service, had not been allowed to rise to their present levels.

Brazil represents another example of a major country which initially shunned legal or administrative controls over state and municipal borrowing, but in recent years has been prompted by the rapid accumulation of subnational government debt to institute such controls.

State debt, both domestic and external, grew rapidly in Brazil from the end of the sixties until the early eighties. The abrupt drying up of external financing during the debt crisis led to widespread defaults by the states, and to the eventual takeover and rescheduling of most of these debts by the federal government in 1989 (for the external portion of the debts) and 1993 (for debts to federal banks). This rescheduling significantly eased the debt servicing the burden on the states. Some of the latter, however, have continued to run up debt towards state owned banks, as well as towards suppliers. Finally, a number of states have resorted extensively to the issue of bonds.

The service of this debt has virtually come to a halt, and with the recent high level of real interest rates, the capitalization of interest payments is leading to an escalation of this debt. The withdrawal of private investors from the market for state bonds, and the drying up of interbank lending to some state banks has forced various forms of intervention by the federal authorities (including the Central Bank), which have effectively shifted the default risk on these types of state debt onto the federal government.

As counterpart for the rescheduling of a part of the state debt, limitations have been introduced in recent years on new state borrowing. Specifically, legal rules and central bank regulations now prohibit a state from borrowing from its own commercial banks. New issues of bonds (other than to refinance maturing ones) are prohibited by a constitutional amendment until the end of this decade. At the end of 1995, the federal government through one of its large banks (Caixa Economica Federal) set up lines of credit to provide short term financial support to the indebted states, as counterpart for the states agreeing to detailed programs of adjustment of their finances. Moreover, specific agreements are being worked out with some of the larger states for a federal takeover of part of the states' debt to their banks.

This brief overview makes clear that the conditions listed above for the effective working of market discipline on state debt were not, and continue not to be, present in Brazil. While it is unfortunate that the need for controls was not recognized and acted upon before state debts reached their present very high levels, it is encouraging that financial support by the federal government to the states is increasingly being made contingent upon specific commitments by the latter to undertake needed corrective actions. The effectiveness of these adjustment programs will depend crucially on firmness in their implementation.

III. A Cooperative Approach to Debt Controls

Closest to sole reliance on market discipline in the spectrum of controls, is an approach whereby limits on the indebtedness of subnational governments are not set by law or dictated by the center, but are arrived at through a negotiation process between the federal and the lower levels of government. Variants of this approach may be found in some European countries, such as the Scandinavian ones, and, in recent years, in Australia.

Under this approach, subnational governments are actively involved in the process of formulation of macroeconomic objectives and of the key fiscal parameters underpinning these objectives. Through this process, agreement is reached on the overall deficit targets for the general government, as well as on the guidelines for growth of main items of revenue and expenditure. Specific limits are then agreed for the financing requirements of individual subnational jurisdictions.

In some countries, like Denmark, negotiations are essentially a bilateral process between the center and individual local governments. In Australia, the process is a multilateral one, taking place within the framework of a long-established Loan Council, in which all states, as well as the center, are represented. Until 1993/94 the Loan Council provided both the forum for negotiation of global debt limits for individual states, and the monitoring of compliance with such limits. The experience of widespread attempts by the states to elude these limits through resort to off-budget operations, innovative financing techniques, such as sale and lease-back arrangements, and through borrowing by state-owned enterprises, has prompted the Council to focus on the ex ante analysis and discussion (as well as ex post monitoring) of the overall net financing requirements of these states, rather than on their outstanding debt. Thus, now the states have to bring to the negotiating table detailed projections of their budgetary operations, and discussions focus on corrective measures, when needed. The Council has also stepped up efforts to promote more effective market discipline on state borrowing, by facilitating the collection and dissemination of timely information on developments in the states' finances.

The cooperative approach has clear advantages in promoting dialogue and exchange of information across various government levels. It also raises the consciousness, in subnational-level policymakers, of macroeconomic implications of their budgetary choices. It seems, however, to work best in countries with an established culture of relative fiscal discipline and conservatism. It may not be effective in preventing a build-up of debt in conditions where either market discipline or the leadership of the central government in economic and fiscal management are weak.

IV. Rule-based approaches to the control of subnational borrowing

A number of countries, both federal and unitary, have relied on approaches to the control of subnational government borrowing which are based on standing rules, specified in the constitution or in laws. Some of these rules set limits on the absolute level of indebtedness of subnational jurisdictions; others specify that borrowing can be resorted to only for specified purposes (typically investment projects); yet others stipulate that new borrowing is permitted up to a level consistent with a maximum allowed service ratio, etc.. Finally, some countries prohibit, or severely restrict certain types of borrowing, which involve greater macroeconomic risks (e.g., borrowing from the central bank). Many countries utilize a combination of such rules.

Rules that limit subnational governments' borrowing to investment purposes (the so-called golden rules) are quite common in industrial countries: examples can be found in Germany, Switzerland and in the majority of the state constitutions in the United States. Those countries which allow short-term borrowing for liquidity purposes generally stipulate that such borrowing has to be repaid by the end of each fiscal year. This is the case, for instance, for some of the states in the United States, and for regional and local governments in Spain.

Examples of rules that "mimic" market discipline by linking limits on the indebtedness of subnational (especially local) governments to the projected debt service on the debt, or to other indicators of their debt-servicing capacity (such as past revenues or the tax base) can also be found in some industrial countries (United States, Spain, Japan), as well as in developing ones.

Rules-based approaches have the obvious advantage of transparency and evenhandedness, as well as of avoiding protracted bargaining between the central and the subnational levels of government, a process the outcome of which often ends up being determining more by short-term political factors than by considerations of sound macroeconomic management. On the other hand, by their very nature, rules-based approaches lack flexibility and, often, end up fostering the development of behavior and practices aimed at circumventing the rules. Such practices include, for instance:

♦ the reclassification of expenditures from current to capital, to escape current budget balance requirements;

♦ the creation of entities whose operations--albeit of a governmental nature--are kept off-budget, and whose debts are not counted against any debt ceilings;

♦ the use of state or local government-owned enterprises to borrow for purposes which should be funded through the relevant government budget;

♦ the use of debt instruments--such as sale and leaseback arrangements or the so-called private revenue bonds in the United States--which are not included in debt limits;

♦ the resort to arrears towards suppliers, which are typically difficult to monitor for inclusion in the public debt ceilings.

This non-exhaustive listing suggests that, to be effective, a rules-based approach needs to be supported by: clear and uniform accounting standards for government entities, strictly limiting, and preferably eliminating, the scope for off-budget operations; comprehensive definitions of what constitutes debt; the setting up of a modern government financial management information system, capable of providing timely and reliable data on all phases of expenditure, as well as on financial operations of the various levels of government; and policies like privatization which minimize the scope for use of financial and nonfinancial enterprises for government purposes.

V. Direct Controls of the Central Government Over Subnational Borrowing

In a number of countries, the central government is empowered with direct control over the borrowing of subnational governments. This control may take alternative forms, including: the setting of annual (or more frequent) limits on the overall debt of individual subnational jurisdictions (or some of its components, e.g., external borrowing); the review and authorization of individual borrowing operations (including approval of the terms and conditions of the operation); and/or the centralization of all government borrowing, with on-lending to subnational governments for approved purposes (generally investment projects). Control powers generally encompass not only the ex ante authorization of proposed borrowing, but also ex post monitoring, on a more or less detailed and timely basis, of the subnational governments' financial operations.

Direct central government controls are, of course, more common in unitary states than in federations. In the United Kingdom until 1988 the central government exercised direct controls on capital spending of local authorities, which varied according to the source of finance of the project. In recent years the central government seeks to influence the level of local governments' capital spending through the amount of financial support (grants or loan approvals) provided to them, and through a requirement that localities set aside a part of their receipts from asset sales to fund new investment. Credit approvals are determined in two parts: a basic amount set on the basis of need criteria, and a supplementary authority earmarked for specific projects.

In Japan, the central government exerts a strong influence on the entire budgetary process of local authorities. Guidelines for borrowing by the latter are set out in the annual "Local Government Fiscal Plan" which is approved by the parliament at the same time as the central government budget. Borrowing is generally approved only for investment purposes, paying regard to both the projected debt service ratio and the overall financing needs of the locality. Much of the financing of local authorities is carried out by the Fiscal Investment and Loan Program, which is effectively a form of government financial intermediation, channeling surplus funds of government entities to the funding of local investment projects.

Tight controls are also exercised by the central government on local government borrowing in France. In Spain, which is not a federation, but has granted considerable autonomy to its regions, central government controls have been tightened in recent years, in an attempt to stem the rapid growth of deficits at the regional level. Currently all bond placements by regional governments (as well as most borrowing by local governments) need prior approval by the central government.

Among federations, in India central government approval is required for borrowing by states which have outstanding indebtedness to the center. The large vertical imbalance which characterizes intergovernmental fiscal relations in that country has made all the states dependent on central government support through grants and loans. Moreover, the central government has created, through portfolio coefficients on financial intermediation, a substantial captive market for the placement of state debt at below market interest rates. Thus, the extensive control of the center over the state finances has, by and large, failed to impose an effective discipline on the latter. India's experience illustrates well the fact that borrowing controls are not a substitute for a sustainable design of intergovernmental fiscal relations, i.e., one which does not give rise to excessive vertical (or horizontal) imbalances.

Several considerations argue in favor of direct central government controls on the external borrowing of subnational governments. First, external debt policy is intimately linked with other macroeconomic policies (monetary and exchange rate policies, and foreign reserve management) which are naturally the responsibility of central-level authorities (in particular, the central bank). Second, a unified approach to foreign markets for sovereign borrowing is likely to result in better terms and conditions than a fragmented one. Third, a deterioration of ratings for one or more of the subnational borrowers may well have "contagion" effects on the ratings for other borrowers, both public and private. Finally, many foreign lenders require an explicit central government guarantee for subnational borrowing. At a minimum, they are likely to count on an implicit guarantee. Thus, the central government is likely, de facto, to bear ultimate responsibility for the subnational governments' foreign debt.

These arguments are less compelling in the case of domestic borrowing of subnational authorities. Detailed administrative control of the latter may involve the central government in micro-level decisions (e.g., about the financing of individual investment projects) which would be best left to the relevant subnational jurisdictions. On balance, effectively and timely monitored aggregate limits on the overall debt of individual jurisdictions, based on market-type criteria like maximum ratios of debt service to revenues, would seem preferable to either centralized borrowing or pre-approval of individual borrowing operations.

VI. Main Conclusions

The review in sections 2-5 of selected country experiences with controls on subnational governments' borrowing shows that the nature and coverage of these controls vary widely, reflecting in particular the individual country's history, the balance of power among the different levels of government, macroeconomic and fiscal conditions, and the state of development of financial markets. Each of the "models" of control analyzed in the previous sections presents advantages and disadvantages, the balance of which would make it more or less suitable to a particular country's circumstances. Moreover, as these circumstances evolve--e.g., as fiscal and macro imbalances improve or worsen--the preferable model may change over time.

From the review of country experiences, it would appear that the following main conclusions can be drawn.

♦ Although appealing in principle, sole reliance on market discipline for government borrowing is unlikely to be appropriate in many circumstances. This is so, because one or more of the conditions for its effective working frequently are not realized in each particular country. However, market discipline can be a useful complement to other forms of borrowing controls, in particular to help contain resort by subnational governments to practices aimed at circumventing those controls. In this respect, greater transparency and dissemination of information on recent and prospective developments in the finances of subnational governments are highly desirable, and governments should be encouraged to make any necessary changes in the legal and institutional framework to promote these objectives. Equally desirable--on other grounds as well as that of fostering more effective market discipline--are steps to reduce government intervention in financial markets, such as the privatization of federal and state banks and the elimination, or at least a substantial reduction, of any requirements for financial intermediaries to hold government debt, as well as of other regulatory or fiscal privileges for government borrowers. In countries with a history of bailouts of insolvent subnational governments by the central government, a firm and sustained refusal to engage in further operations of this kind will be necessary to change expectations and behaviors of market participants vis-a-vis subnational government borrowing. It must be recognized that this may be a prolonged process, the more so the longer the previous history of bailouts.

♦ The increasing worldwide trend towards devolution of spending and revenue-raising responsibilities to subnational governments seems likely to come into growing conflict with systems of administrative controls by the central government on subnational borrowing (involving e.g., a centralization of borrowing or approval of individual loan operations). While the case--on macromanagement and perhaps cost effectiveness grounds--for administrative controls appears strong as concerns external financing, it is clearly less so for domestic borrowing, for the reasons indicated in section 5 above. It would not, therefore, be surprising to see administrative controls on domestic subnational borrowing decline in importance in the years ahead.

♦ Rules-based approaches to debt control would appear preferable, in terms of transparency and certainty, to administrative controls and also to statutory limits defined in the context of the annual budget process, the outcome of which may be unduly influenced by short-term political bargaining. There is a clear macroeconomic rationale for barring all levels of government from borrowing from the central bank (or at a minimum severely restricting this type of borrowing). Also, as indicated above, borrowing abroad by subnational governments, if not consolidated through the central government, should be strictly limited, to e.g., borrowing from multilateral agencies for specific investment projects. In principle, a good case can be made for limiting all borrowing to investment purposes. However, the so-called golden rule may not be sufficiently restrictive in countries which need to generate governments savings to finance at least a part of public investment. Moreover, it may not be desirable to allow government borrowing to finance investments which do not have an adequate rate of economic and social return. Finally, in practice it may be difficult to avoid circumvention of the rule through the inclusion in investments of certain expenditures for current purposes.

These considerations would seem to argue for setting global limits on the debt of individual subnational jurisdictions on the basis of criteria which mimic market discipline, such as the current and projected levels of service of the debt in relation to the jurisdictions' revenues. It is clearly crucial that the projection of the debt service and of revenues, utilized in testing compliance with the ceiling, be realistic and indeed preferably conservative ones. It is equally important that a comprehensive definition of the debt subject to the ceiling be adopted (including, to the extent feasible, extrabudgetary operations, suppliers' credits, guarantees to credits contracted by the subnational government's enterprises, and relevant financial innovations, such as sale and leaseback arrangements).

♦ Finally, even in the context of rules-based approaches, there seems to be scope for increased cooperation of all levels of government in containing (or reversing, if needed) the growth of public debt. Enhanced involvement of the subnational governments (especially at the regional/state level) in formulating and implementing medium-term fiscal adjustment programs (along the lines of the approach recently adopted in Australia) should result in greater responsabilization of these governments in the conduct of their budgetary affairs. A multilateral forum for discussion of budgetary policies and prospects of various levels of government should facilitate the recognition of any need for reforms of the existing system of intergovernmental fiscal relations, and help muster adequate political consensus for such reforms. Effective political and intellectual leadership by the central government in such a forum remains essential, and may be viewed as the natural evolution of the traditional administrative controls in an increasingly decentralized world.