

# Deficit Reduction, Decentralization Highlight Need to Manage Subnational Government Debt

**R**ising concern over high public-debt-to-GDP ratios and increasing decentralization of expenditure and revenue-raising responsibilities have heightened the importance of properly managing debt of the subnational governments. A recently published IMF Paper on Policy Analysis and Assessment, *Borrowing by Subnational Governments: Issues and Selected International Experiences*, by Teresa Ter-Minassian, examines four major approaches to managing subnational debt. Ter-Minassian concludes that approaches that rely on transparent standing rules to limit such debt, supported by the dissemination of comprehensive and timely information on the finances of subnational governments to promote market discipline, are likely to prove most effective in an environment of increasing decentralization.

## Approaches to Subnational Debt

Subnational debt is a concern, explains Ter-Minassian, whether a country employs a federal or unitary structure of government and whether or not it has accumulated substantial debt at the subnational level. A credible fiscal adjustment effort can be undercut if it fails to address existing subnational debt or the potential for a transfer of fiscal problems to lower levels of government. The experiences of a number of countries suggest that central government controls over subnational government borrowing tend to be looser where fiscal discipline is poor and where fiscal and macroeconomic imbalances remain unaddressed. They may also be looser where financial markets are well developed and can exert effective discipline on the borrowing of subnational governments. A broad survey of country

experiences identifies four principal approaches to managing subnational debt. *Market Discipline.* Sole reliance on market discipline can be effective, Ter-Minassian notes, but the preconditions for its use are exacting, and few countries satisfy them. Markets must be free and open (without regulations that place government in a privileged borrower position); potential lenders must have sufficient information to assess the borrower's debt level and repayment capacity; there should be no expectation of a bailout in the event of a default; and the institutional infrastructure must respond in a timely fashion to market signals.

In practice, lenders in developing countries typically lack access to timely information on subnational debt levels. Many countries facilitate the placement of government securities at a below-market cost through portfolio requirements on financial intermediaries, and a number of countries have intervened to stave off the default of subnational governments. Also, preoccupation with often short electoral cycles commonly leaves subnational governments unresponsive to early warning signals from financial markets.

Relatively few countries rely solely on market discipline. Canada, which does, has had a mixed record. Canadian provinces have no constitutional or legal limits on borrowing, but their debt and debt-servicing capacity are closely monitored by financial markets, principally through the major debt rating agencies. Despite a clear deterioration in debt ratings and a sizable increase in risk premiums on some provincial bonds, provincial debt has climbed steadily, with provincial governments beginning only recently to

design and implement fiscal adjustment. This "recognition lag" may arguably, Ter-Minassian says, necessitate a sharper and more painful retrenchment.

Brazil until recently also shunned legal and administrative controls over state and municipal borrowing, allowing this debt to accumulate rapidly from the end of the 1960s through the 1980s. The federal government assumed and rescheduled most external debt in 1989 and debt to federal banks in 1993. But in some instances, states continued to amass debt to state-owned banks, and others resorted excessively to the issuance of bonds. Subsequently, in the face of high interest rates and the withdrawal of private lenders from state securities, several states faced default. Intervention shifted the default risk to the federal government, but the severity of the problem led Brazil to re-examine its stance on controls. New legal rules and central bank regulations prohibit states from borrowing from their own banks. A constitutional amendment now bans the issuance of state bonds until the end of this decade. And the federal government, through one of its major banks, has extended lines of credit for indebted states that agree to initiate fiscal adjustment programs.

*Cooperative Approach.* A cooperative approach eschews legal or centrally dictated limits in favor of a negotiated agreement between the federal and other levels of government. This approach, which actively involves subnational governments in formulating budgetary policies within an overall macroeconomic framework, has found adherents in some European countries—notably in Scandinavia—and, more recently, in Australia. In Australia, the process has been conducted

within a multilateral forum in which all states and the center are represented through the Loan Council. States submit detailed projections of their budgetary operations, and discussions emphasize corrective measures, when needed. The Council also facilitates the collection and dissemination of data on state finances. Other countries, such as Denmark, use bilateral negotiations between individual local governments and the center.

The cooperative approach has clear advantages in improving communication and promoting the exchange of information across levels of government. It also increases the awareness at all government levels of the macroeconomic implications of budgetary choices. But the cooperative approach works best, Ter-Minassian cautions, when a culture of fiscal discipline is already in place.

**Rules-Based Approaches.** A number of countries rely on constitutional or legal provisions to control subnational government borrowing. Some limit the absolute level of indebtedness; others permit borrowing only for specific purposes (typically investment); others permit borrowing only up to a maximum debt-service ratio; and still others prohibit, or severely limit, borrowing that involves certain types of macroeconomic risk (such as borrowing from the central bank). Many countries use some combination of these constraints.

Rules limiting borrowing to investments are quite common, notes Ter-Minassian, in industrial countries and in most U.S. state constitutions. Some countries, such as Spain, allow regional and local governments to borrow short term for liquidity purposes but require repayment by the end of the fiscal year. Some industrial countries (notably the United States, Spain, and Japan) and a number of developing countries link limits on subnational government indebtedness to projected debt service or

other indicators of debt-servicing capacity.

Rules-based approaches have the advantages of transparency and evenhandedness, Ter-Minassian says. They also sidestep the protracted bargaining that can characterize the cooperative approach. But rules, by their very nature, lack flexibility and often inspire inventive circumvention. To be effective, says Ter-Minassian, a rules-based approach must be supported by clear and uniform accounting standards that ideally eliminate off-budget activities, and must also be bolstered by a comprehensive definition of debt, modern government financial management information systems, and privatization efforts that effectively minimize the opportunity to use public enterprises and banks as a source of government financing.

**Direct Controls.** In a number of countries—principally those with a unitary structure of government—the central government directly controls subnational government borrowing by setting annual limits, reviewing and authorizing individual borrowing operations, or centralizing all government borrowing. In the United Kingdom, until 1988, the central government exercised direct controls over the local governments' capital spending. More recently it has sought to influence the level of spending on capital projects through grants and loans approved for local governments.

In Japan, the central government exerts a strong influence over the entire budget process of local authorities. Borrowing is generally approved solely for investment. In Spain, which affords its regions considerable autonomy, the central government has



**Ter-Minassian: Market discipline is an effective supplementary means of controlling subnational debt.**

moved to address rapidly growing regional debt. Spain now requires prior central government approval for all bond placements. In India, extensive central government controls have largely failed to impose discipline on the states. Ter-Minassian notes that borrowing controls are no substitute for properly designed, and sustainable, intergovernmental fiscal relations.

Several considerations argue for direct central government controls on the external borrowing of subnational governments. The intimate link between external debt and monetary and exchange rate policy argues for a strong role for the center in managing a country's external debt. Also, a sovereign borrower is likely to garner better terms than provincial or local governments, while a deteriorating rating in one subnational entity would likely have a damaging impact on other local government borrowing. Ultimately, many foreign lenders require an explicit central government guarantee for subnational borrowing, and the central government is likely to bear responsibility for foreign debt.

The center has a very real interest in seeing it handled responsibly.

For domestic borrowing, however, micromanaging may be counterproductive. Ter-Minassian believes that “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, appear preferable to either centralized borrowing or preapproval of individual borrowing operations.”

### Conclusions

Market discipline is more likely to be effective as a supplementary rather than a primary means of controlling subnational government debt, Ter-Minassian concludes. In this regard, greater transparency and dissemination of information on subnational government finances are “highly desirable.” Also desirable are efforts to reduce government intervention in the financial markets—notably privatization of state and federal banks, and the elimination or substantial reduction of requirements on financial intermediaries to hold government debt or to accord special privileges to government borrowers. Countries that have bailed out insolvent subnational governments in the past face a daunting task in convincing market participants that such bailouts will not occur in the future.

In view of the continuing trend toward decentralized expenditure and revenue-raising responsibilities, administrative controls on domestic borrowing are likely to decline in importance in the future, says Ter-Minassian. A rules-based approach has the advantage of greater transparency and certainty. There is a clear macroeconomic rationale for barring all government borrowing from central banks. Limiting borrowing to investment purposes, however, may pose a variety of problems. It may not be sufficiently restric-

tive to generate needed government savings or to ensure that investments are tied to adequate economic and social returns.

These concerns seem to argue, says Ter-Minassian, for setting overall debt limits on individual subnational jurisdictions, and for doing so on the basis of criteria that mimic market discipline, such as current and projected debt service in relation to projected revenues. Realistic, even conservative, projections must be used, as well as a comprehensive definition of debt. Greater involvement of subnational governments in formulating and implementing medium-term fiscal adjustment could complement these overall limits. Such involvement is likely to broaden recognition of the importance of responsible budget policies, and to develop the needed political consensus to carry out fiscal adjustments in a country. Of course, Ter-Minassian concludes, there remains no substitute for effective political and intellectual leadership from the central government. ■

Copies of IMF Paper on Policy Analysis and Assessment 96/4, *Borrowing by Subnational Governments: Issues and Selected International Experiences*, by Teresa Ter-Minassian, are available for \$7.00 from Publication Services, Box XS600, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org