



Decentralizing borrowing powers

With sound intergovernmental fiscal relations and proper regulation, subnational borrowing is both feasible and desirable. Where these conditions are not in place, subnational borrowing may lead to unplanned liabilities for central government and thus should be restricted while enabling institutions are developed.

The debt crisis among subnational governments in Brazil, the inflationary impact of subnational financing in Argentina, and city bankruptcies in the United States are often used to illustrate the potential macroeconomic hazards of decentralizing borrowing powers. The argument focuses on the impact of a possible moral hazard problem—namely, that access to financial markets by subnational governments may generate unplanned liabilities for central government.

Yet the academic literature and country experiences do not suggest an inevitable adverse link between decentralized borrowing powers and central government's ability to maintain fiscal discipline and macroeconomic stability. Rather, the key seems to lie in the design of fiscal decentralization, particularly the regulatory framework under which borrowing powers are decentralized. (For a literature review and discussion see Litvack, Ahmad, and Bird 1998.) Designing and implementing this framework are no easy task. Still, where the necessary conditions are in place, subnational borrowing is both feasible and desirable. Where these conditions are not in place, subnational borrowing should be restricted and institutions developed to enable it in the long run.

Why is access to financial markets important?

Subnational governments require access to financial markets for two main reasons. The first is to finance lumpy capital spend-

ing. It would be inefficient to finance such capital investment by increasing taxes. In addition, because the benefits of such investments often span several decades, equity considerations suggest that future generations should participate in the financing. Capital markets provide this intertemporal link.

Second, access to financial markets can foster political accountability. The pricing of capital by markets can signal the poor performance of subnational governments by raising interest rates or simply blocking access.

Subnational mechanisms for accessing capital markets

Subnational government can access capital markets through:

- Direct borrowing by central government that is onlent to subnational tiers.
- A public financial intermediary.
- Direct borrowing.
- Market decentralization of public services.

Policymakers should consider several objectives when weighing the merits of each channel, including minimizing the political allocation of credit, reducing or eliminating implicit liabilities for an upper-tier government, and strengthening capital markets.

Although borrowing through the central government ensures access by subnational governments to long-term finance, credit allocated in this manner may get embroiled in a political process, leading to inefficient investments. Intermediation

How can
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without creating
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Regulatory design issues start with the question of transparency, initially through better information systems

by a public financial intermediary can also have this shortcoming (depending on its design), with the additional disadvantage that the debt of public financial intermediaries is an implicit obligation of central government.

Additional complications can occur when multiple channels are used. For example, South Africa's central government has created a public infrastructure bank that operates alongside a well-developed private capital market (Ahmad 1996). Unless the regulatory framework for municipal borrowing clearly delineates a complementary role for the public and private financial systems, the public system may displace the private system, or the public system may get saddled with high-risk clients.

Direct access to capital markets, where possible, offers potential for a more transparent, market-based relationship to develop and for a better chance of enforcing a hard budget constraint between levels of government. Macroeconomic concerns about moral hazard—based on the assumption by capital markets that borrowing by subnational governments is ultimately backed by central government—may arise with direct borrowing from private financial markets. Managing such risks through an appropriate regulatory framework—while allowing market discipline to guide the allocation of capital—is probably the most efficient way to allow subnational access to financial markets.

Designing the regulatory framework for subnational borrowing

Better information systems, bankruptcy laws, and access to tax bases, separate fiscal and financial systems, market decentralization, and supervision and legislation help impose budget discipline at all tiers of government and enable borrowing to be decentralized.

Information systems

Regulatory design issues start with the question of transparency, initially through better information systems. These systems should include standardized accounting procedures for subnational governments and

provide public information on their liabilities and repayment capacity.

Bankruptcy laws

By itself, better disclosure will not curb moral hazard—penalties are also needed. In particular, explicit bankruptcy procedures (such as the financial control boards in the United States or system of court-appointed receiverships in New Zealand) may need to be legislated. (Central government can also legislate intermediate steps with an associated penalty schedule—for example, setting debt thresholds that, if overstepped, then require central approval for future borrowing or even cause the loss of borrowing powers altogether. Too many central controls may, however, make central authorities implicitly liable for subnational borrowing. Thus it may be preferable to require full disclosure and legislate bankruptcy procedures without introducing intermediate controls.) Such mechanisms must ensure that the delivery of basic services is allowed to continue, even if at a reduced level, while management and financial restructuring proceed. Otherwise there will be enormous pressure for central bailouts.

Tax bases

Moral hazard can also be eased by ensuring that subnational governments have access to own taxes (within a predictable system of intergovernmental finance), which can be pledged as collateral. Without such direct fiscal backing, markets may view any borrowing by subnational governments as implicitly backed by the central government. Thus own taxes are an important prerequisite for subnational access to finance and for limiting moral hazard.

Separate fiscal and financial systems

Equally important is keeping fiscal and financial systems separate when designing intergovernmental systems. Indeed, the lack of separation between fiscal and financial systems—rather than decentralization—may have led to macroeconomic instability in some countries, as the web of implicit obligations suddenly appeared as explicit budget commitments.

In Argentina, for example, provincial government deficits have been partly financed by provincial banks, many of which have gone bankrupt. The Central Bank's policy of managing these banks and absorbing their losses provided provincial governments with a circuitous mechanism of inflationary finance. It also weakened incentives for fiscal discipline at the provincial level. In Brazil evidence suggests that a soft budget constraint between tiers of government can exist through the banking system despite a sound intergovernmental fiscal system (Dillinger 1997). Similarly, in China the weak revenue base of the center has put political pressure on the People's Bank of China to offer credit to lower-level governments. Such policy-based lending can have a negative impact on macroeconomic price stability and, presumably, fiscal discipline at the subnational level (Lall and Hofman 1995).

Several mechanisms can be used to separate fiscal and financial systems. First, an independent central bank is a key element of a hard budget constraint. Second, where possible, the public sector must get out of the financial system (box 1). (At the very least, as Argentina suggests, subnational public financial institutions should be closed.) Although this move includes privatizing the banking system, privatization is insufficient to enforce the separation. As the U.S. sav-

ings and loan debacle and recent East Asian financial crisis suggest, private banks must be supervised with a clear prudential regulatory framework that monitors the level and nature of their aggregate liabilities. Finally, if central authorities grant subsidies to subnational governments, the subsidies should be provided explicitly through the fiscal transfer system rather than implicitly through the financial sector.

Market decentralization

Market decentralization may also reduce moral hazard. Privatization of public infrastructure may enable the application of private sector bankruptcy laws and allow other private companies to bid for the assets in case of financial difficulties—not a viable option under public ownership. To implement such an option, however, governments must ensure that a sector contains multiple service deliverers. Private participation creates options for accessing financial equity as well as debt, creating an incentive for “equity to monitor debt” that is not available in public financing systems. In addition, unbundling may shrink the entity involved, thus avoiding the “too big to fail” syndrome often associated with bailouts.

Supervision and legislation

Finally, the backdoor channels that lead to financial liabilities should be monitored

Central subsidies should be provided explicitly through the fiscal transfer system rather than implicitly through the financial sector

Box 1 Evolution of capital markets and decentralization of borrowing powers

In countries without a domestic capital market, it may be preferable to have central fiscal transfers—from central borrowing from international sources—provide resources to subnational governments while policy efforts focus on developing a private commercial banking system. This approach avoids the creation of public financial intermediaries, keeps the fiscal and financial sectors separate, and can offer a better starting point for a municipal finance system.

As the private banking system establishes itself, long-term finance can be provided through centrally funded discount facilities. These facilities stretch the terms of commercial bank lending to municipalities but take on only the maturity risk. Commercial banks retain the credit risk for their retail

lending, thus preserving the separation of risks between the public and private sectors. Colombia offers lessons for designing discount facilities.

The need for discount facilities will disappear as capital markets emerge with financial instruments offering long-term finance. And as long as the fiscal system is well designed, subnational governments will be able to secure longer maturities. Still, for fiscally weak municipalities the fiscal transfer system will remain an important vehicle for accessing funds. In more developed capital markets, private credit rating agencies and bond insurance agencies offer a market-based mechanism for monitoring and regulating subnational borrowing. These institutions, however, require public sector regulation.

Financial
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and, where possible, closed. In particular, legislation must ensure that subnational governments are not allowed to dip into pension funds or use subnational corporations to borrow, or must explicitly include such borrowing in subnational debt. In addition, balanced budget requirements for subnational governments can ensure that current accounts are balanced by the end of each fiscal year, so that borrowing to match expenditure and revenue streams does not lead to the financing of current account deficits.

Foreign borrowing

The question of direct access to international capital markets by subnational governments is further complicated by issues of capital market liberalization and foreign exchange regimes. This overall context will determine whether direct borrowing by subnational governments in international markets should be permitted. Although this note is focused on decentralizing borrowing powers in the domestic market, the regulatory framework suggested here applies equally to local and foreign borrowing.

Next steps

Financial decentralization—allowing subnational governments direct access to capital markets—is an important complement to the devolution of fiscal powers to regional and local authorities. If properly designed, decentralization of borrowing powers can add to the gains in efficiency and governance expected from fiscal decentralization. But effective financial decentralization requires a well-designed regulatory framework.

This is not to imply an all or nothing scenario: financial decentralization can be implemented using a phased, asymmetric approach. Policies may include sequencing fiscal decentralization before decentralizing borrowing; granting large urban

centers (which usually have strong fiscal resources and management capacity) quicker access to financial markets and perhaps even foreign markets; implementing market decentralization as a first step; and replacing implicit resource transfers through public financial institutions with explicit fiscal transfers. The challenge is to design the regulatory framework for financial decentralization; debating whether financial decentralization is good or bad may be a moot point given emerging local capital markets and a strong political push in many countries to decentralize powers to subnational governments.

Further readings

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