

SNTA Briefs

Sharing knowledge, experiences, and innovations in sub-sovereign financing for infrastructure

Enabling Environment for Sub National Government¹ Debt

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The enabling environment is the national government's legal, regulatory, and institutional framework and debt market conditions that govern sub-national governments' (SNGs) borrowing. When planning to borrow, SNG finance directors should assess the borrowing constraints imposed by the enabling environment.

The most critical element of the enabling environment is the nation's decentralization and fiscal laws governing the SNG revenues used to secure or guarantee debt repayment. Decentralization laws determine SNG revenue raising capability and expenditure requirements to deliver local services. Laws and regulations also determine which revenues an SNG uses to repay debt and the total outstanding debt, or debt capacity, an SNG can support with these revenues. National government's fiscal laws that regulate SNG debt, commercial banks, and the stock markets also contribute to the supply and demand of SNG debt.

Macroeconomic conditions also play a significant role in the supply and demand for SNG debt. The most direct impact on the SNG debt market is the central bank's interest rate policy that shapes the government's benchmark "yield curve"². The benchmark yield curve sets the interest rate floor for public (including SNG) and corporate debt.

Government fiscal and monetary policy also contributes to the enabling environment. In addition to the government yield curve, fiscal and monetary policy drives the underlying economic base of SNG revenue collection, as well as inflation, which has a major

impact on SNGs' annual operating balance.

The Implications of Decentralization for SNG Borrowing

The influence of the nation's decentralization laws and policies constrains the types of revenues an SNG can use to repay a borrowing. The revenue source must be eligible to repay debt; comply with any restrictions on the amounts used for SNG's operating or capital budget; and comply with national government limits on SNG outstanding debt. The purpose of the borrowing and the selection of the revenue source for debt payments are influenced by national decentralization laws.

A country's decentralization laws and policies pertaining to revenue and expenditure assignments also have a significant impact on SNG ability to generate an operating surplus and debt capacity.

- Revenue assignments between national and SNG political jurisdictions, whether local taxes, inter-government transfers, or fees for service, provide operating and capital budget support, in addition to repayment of SNG debt.
- Expenditure assignments determine SNG operating and investment costs that for SNG service delivery obligations.

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Government fiscal and monetary policy contributes to the enabling environment

Unless SNG revenue raising capability matches its required operating and capital expenditures, it may experience increased budget deficits, poorer service delivery, reduced debt capacity, and a deteriorating credit rating. This inconsistency contributes to operating budget pressure, leading to budget deficits and SNG short-term borrowing, often by delaying vendor payments. Budget pressure may also result in high interest rates charged by commercial banks for SNG lines of credit and other forms of short-term financing. Another potential outcome of revenue and expenditure assignment inconsistency is delayed SNG debt service payments on its long-term borrowing or outright defaults. Finance directors should take these factors into account in planning an SNG debt offering, whether a commercial bank loan or local capital market bond issue.

In other cases SNGs have increased responsibility to deliver social services, but may lack the legal power to increase fees and charges for these services. This contributes to greater budget deficits and reduces SNG debt capacity, and could lead to non-compliance with the mandate. Required expenditure mandates without concomitant revenue raising capability may also have an impact on national and SNG government debt management.

SNG Debt Management and Moral Hazard

Mandated SNG operating and capital expenditures may require SNGs to undertake additional borrowing³ to comply with existing social service delivery obligations resulting from decentralization reforms. This increases not only SNG debt, but also a country's total outstanding public debt.

To avoid rapidly increasing SNG debt, whether created by unfunded mandates or for other reasons, many national governments have instituted fiscal reforms after the 1997 Asia financial crisis. However, governments should recognize that inconsistent decentralization policies that do not provide SNGs with sufficient revenue raising capacity, in addition to their expanded expenditure mandates, might result in over-indebted SNGs and deteriorate a country's general macroeconomic conditions in the long term.

Fiscal reforms introduced after the 1997 crisis seek to control SNG debt through a variety of regulatory requirements and indicators, such as a maximum debt service to current revenues ratio, among others, as in Colombia and Peru⁴. In other cases, national governments must approve direct debt issued by states, as in India. These SNG debt controls are an attempt by national governments to avoid SNG bailouts and negative macroeconomic consequences.

Sufficiently large SNG bailouts may contribute to increasing inflation, as was the case in Brazil in the early 1990s. To control SNG debt, Brazil passed the Fiscal Responsibility Law (2000) that does not allow SNGs to borrow. However in some Brazilian states and some other countries, local governments have circumvented SNG legal borrowing restrictions and managed to issue debt in the local markets⁵.

Regulatory reforms and adequate monitoring of SNG debt may help improve a country's fiscal management. But without coordinating debt management with implementation of appropriate revenue and expenditure assignments, SNG debt may grow and create "moral hazard" problems for the central government.

Moral hazard arises when investors of SNG debt (and rating agencies) believe that the national government will step-in to prevent SNG default, as was the case in Brazil in the late 1980s and early 1990s. In countries with mature capital markets and more closely aligned revenue and expenditure assignments between national governments and SNGs, such as the US, Canada, and France, central governments will not intervene in transactions between subnational governments and their creditors, relying on market discipline to control subnational debt.

Developing countries with SNG debt controls are moving in the direction of the mature capital markets to limit moral hazard and encourage sustainable SNG borrowing. However, unless the national government's fiscal decentralization policies concurrently removes inconsistencies in revenue and expenditure assignments between the different government tiers, creditors will continue to require explicit or implicit national government guarantees, exacerbating moral hazard, and limit development of local capital markets.

Macroeconomic Conditions, SNG Economic Base and Debt Capacity

A country's general macroeconomic condition is the foundation of the economic base underlying SNG revenue sources; inflation related to operating and capital budget expenditures; and/ SNG's cost of capital that drives interest rates. These macroeconomic enabling conditions are beyond the SNG's control, but form the basis of an SNG's annual operating and capital budgeting process and SNG debt management.

SNG's may repay debt from three general sources, depending on the type of debt it issues: i) general obligation or issuer debt secured by all available SNG revenues, a "full faith and credit" pledge of the local government; ii) tax supported debt secured by a pledge of a specific tax, fee, or other revenue source, such as co-participation debt issued by provinces and municipalities in Argentina ⁶ ; and iii) revenue or enterprise debt secured by tariffs or charges paid by the customer for services delivered by the SNG or an SNG owned enterprise, such as a water and sewer company or department. The underlying macroeconomic conditions that support the forecast of revenues generated over the life of the debt are fundamental criteria that credit rating agencies use to determine the SNG's ability to repay debt obligations.

In addition to securing debt, SNG inter-governmental transfers, own source revenue, and service fees and charges, fund operating expenditures. These operating expenses compete with creditor debt service payments over the life of outstanding SNG debt obligations. Therefore, it is crucial for SNG finance directors to insure that debt service payments over the life of its total outstanding debt do not result in future operating budget deficits. This requires the finance director to simulate an SNG's future operating budget and the SNG's debt capacity ⁷. How much debt can an SNG support with the projected annual net operating balance over the maturity of any proposed borrowing? Macroeconomic assumptions underlying the revenue projections, the purpose of a borrowing, and SNG implicit or explicit financial policies have a significant impact on the SNG's future financial health. The purpose of a borrowing determines whether an investment will generate a fee for service, such as water tariffs charged to customers, or does not gener-

ate revenue, such as construction of a new city hall.

If the SNG has a financial policy to recover all costs, including debt, for a project that generates its own revenues, the project has to charge a tariff or fee sufficient to repay the debt and comply with service delivery performance standards (full cost recovery).

If the SNG determines the tariff is not affordable and not sufficient to repay the debt and operate the water supply service, it may have a policy to subsidize debt service payments with general budget operating revenues. However, if the SNG also wants to build a new city hall, it must use general operating revenues to repay this debt. The SNG has to determine if it has the capacity to support borrowing for both the water supply and city hall investments. This requires a financial analysis to decide if the SNG's operating budget generates a sufficient surplus for future water and city hall debt service payments.

If the financial analysis shows that general budget and project specific revenues are insufficient to pay SNG cumulative debt service, the SNG has to either raise existing tax rates and fees; introduce new tax and fee sources of revenue; increase existing SNG operating efficiency; or reduce the amount of investments. The national government's fiscal and decentralization laws determine the SNG's flexibility to change the rate basis to increase revenues and generate an operating surplus. They also impact the extent to which an SNG can improve operating efficiencies, for example by outsourcing services and reducing labor costs, assuming this approach is politically feasible.

Macroeconomic and financial system assumptions in the financial planning analysis also contribute to the forecast of SNG debt capacity and effect a SNG's cost of capital. SNG debt capacity is driven by the interest rate, price (together, the yield), and duration ⁸ of its consolidated debt ⁹, among other factors. The national government establishes the "risk free" benchmark yield curve for all capital market debt, including debt issued by SNGs. The sovereign yield curve represents the lowest yielding fixed income securities in the domestic capital market. SNG yields are priced off the sovereign yield curve benchmark. The "spread" above the sovereign yield is the creditor's perception of the SNG's risk relative to the risk-free sovereign. An SNG's

A country's general macroeconomic condition is the foundation of the economic base underlying SNG revenue sources

The Sub-National Technical Assistance (SNTA) Program

As more and more countries decentralize, the provision of infrastructure is increasingly becoming the responsibility of sub-national authorities (local governments and public utilities). These authorities are finding it necessary to seek long term private financing for their infrastructure projects. Using annual budget allocations to build infrastructure is difficult to manage because the funds required vary greatly from year to year. Long term debt financing allows sub-national authorities to smooth out the annual funding requirement by borrowing a large amount of capital at one time and then repaying the debt in predictable annual increments small enough to make the project affordable to the people served. The Public Private Infrastructure Advisory Facility (PPIAF) works with sub-national authorities to enable access to private financing on the best possible terms, and shares the lessons learned from its global experience.



relative risk is a function of the type and amount of revenues used to support debt service payments, among other key criteria used by rating agencies to determine the credit rating for the SNG debt issue (see Credit Rating Briefing). Relative risk is also driven by the extent to which investors view SNG debt with an implicit or explicit national government guarantee. National government guarantee of SNG debt requires a smaller spread than debt issued by SNGs that do not have a guarantee. This perception may be driven by the investor's understanding of the status of decentralization and political relationships of SNG officials to national officials.

SNTABRIEFS

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Notes

¹ For purposes of this paper, any political jurisdiction below the national government, such as states, regions, province, cities, districts, etc., defined in the national constitution are considered as an SNG.

² A line that plots the interest rates, at a set point in time, of government bonds with different maturity dates. This yield curve is used as a benchmark to price other "risky" debt in the market, such as mortgage rates or bank lending rates.

³ Short-term borrowing, less than one year, for operating deficits and long-term borrowing for capital program investments.

⁴ Regulation 955 of the Fiscal Decentralization Law requires the Ministry of Finance in Peru to monitor seven SNG debt indicators. The Ministry can stop an SNG borrowing if it does not comply with the following indicators:

- Total Outstanding Debt Stock cannot exceed 100% of Current Revenues
- Total Debt Service Payments cannot exceed 25% of Current Revenues
- Average Primary Budget Result over 3 years must be greater than 0;
- Short Term Debt must be less than or equal to Current Revenues/12;
- Stock of Debt without a National Government Guarantee must be less than 40% of Current Revenues
- Total Debt Service without a National Government Guarantee cannot exceed 10% of Current Revenues
- Year over year Real net financial expenditure growth cannot exceed 3%

⁵ The State of Rio de Janeiro issued asset backed securities (ABS) through the sale of its oil royalties in the local market. The ABS was not considered "debt" by regulators, but a sale of assets. Similarly in China, local governments have issued debt by municipal owned corporations and special entities that are not considered as direct municipal debt by the national government. However, in China's case, the national government recognized the need to stimulate the local economy as a result of the 2008/09 global financial crisis and allowed SNGs to issue several hundred billion dollars of debt. Some analysts consider this debt unsustainable that may lead to a local government debt crisis.

⁶ Co-participation revenues are constitutionally mandated transfers from central government, on a formula basis, to the provinces and municipalities in Argentina. Many other countries have similar revenue transfers from national to local governments that are also used to secure SNG debt obligations.

⁷ Other financial policies to protect annual operating balance include a "rainy day reserve fund"; prohibitions on incurring debt denominated in a foreign currency; debt maturity structure that does not allow a large portion of all outstanding debt to come due in the same year; restrictions on the amount of short-term debt to total outstanding debt; maintaining, at a minimum, an investment grade credit rating; investment of surplus SNG funds in fixed income securities rated investment grade or higher, etc.

⁸ Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. (See <http://www.investopedia.com/terms/d/duration.asp#axzz1oMrUZQ4W>).

⁹ Many SNGs own enterprises that deliver services, such as water, sewer and solid waste companies. The debt of these companies, although reported in independent financial statements, is a legal liability of the SNG. Investors consolidate the debt of the enterprises with the SNGs debt to determine total outstanding SNG debt and cumulative debt service payments.