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MUNICIPAL INDEBTEDNESS AND DEBT MANAGEMENT

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***Abstract*—**Efficient and effective management of local finances is a prerequisite for a sustainable and inclusive development, thus it is necessary to strengthen individual and organizational capacities of municipalities in order to ensure financing resources and to use these funds in accordance with the principles of a good municipality. The system for financing municipalities should be adjusted to the operations performed by municipalities.

***Keywords*—**management, individual and organizational capacities of municipalities, capital expenditures, capital market, central authorities, local authorities.

I. INTRODUCTION

DEBT crisis of subnational municipalities in Brasil, inflationary influence of subnational financing in Argentina and bankruptcy at a municipal level in the United States were often used as an illustration of possible macro issues of decentralizing authorization for municipalities to borrow. The argument is focused on the moral hazard problem , namely, on the proposition that the access of subnational municipalities to financial markets can include implicit or explicit guarantees of the central government which lead to unscrupulous actions of those who lend as well as of subnational municipalities , and eventually give not planning of fiscal recommendations for central governments.

Academic literature and experience of a country, however, do not propose an a priori negative link between decentralizing authorizations to borrow and the possibility of the central government to maintain fiscal decentralization , and especially the design of a regulatory frame within which the authorization to borrow has been decentralized. Difficulty in creating and implementing this frame should not be underestimated. Still, when required prerequisites are convenient, local loans are feasible and desirable. When they are convenient, loans should be limited and institutions developed to support them in the long run.

There are three primary reasons why the access to financial markets is concerned as municipalities.

- Financing capital expenditures – municipalities are often responsible of public investments which are inherently difficult to handle. Financing such capital investments by means of increasing current taxes would not be efficient. Besides, since the benefits from such investments last for several decades, examination of justice suggest that future generations should take part in financing. Capital markets provide this connection between different periods of time.
- Adjustment of expenditures and tax flows – within a certain fiscal year , arising expenditures and intake of taxes do not have to be completely synchronized. The access to financial markets offers a possibility to reconcile these discrepancies.
- Giving encouragement to political responsibility – price determination of the capital by the market can provide an independent mechanism for encouraging political responsibility – markets can signal bad performance results of subnational municipalities through the increase of interest rates or simply by blocking the access.

In reference to this, there are at least four channels through which municipalities can access capital markets :

- Direct borrowing from central government and further borrowing to subnational levels ;
- With the help of a public intermediary such as a financial parastate ;
- Direct borrowing from capital markets;
- Through market decentralization of public services , where possible .

When evaluating positive features of a channel in comparison to the other , policy makers have to take into account several factors. The chosen channel should minimize or eliminate inefficient political allocation of a credit. Any implicit responsibility of higher levels of government should explicitly be recognized and reduced or eliminated. Finally, selection should be done with the attitude towards strengthening capital markets. Although borrowing through the central government guarantees to subnational municipalities the access to long-term finances , international experience proves that a credit allocated in this way can , eventually, be entangled into a political process. On such conditions , the capital does not have to go to the most productive ones , but to those who have the greatest political wisdom, resulting in inefficient funds borrowed from the government and investments which later proves to be unproductive.

Mediation of a public financial intermediary can also have these deficiency with the addition of another deficiency – that is to say, the debt of public financial intermediaries is an implicit obligation of the central government. Additional complications can appear when using multiple channels. For example, in South Africa, the Government created a public infrastructural bank which does business with a well developed capital market. If the regulatory frame for municipal loans does not clearly specify the complementary role of the public and private financial system , some discrepancies can emerge so that the public sector can either dislocate the private financial system or the public sector can be burdened by highly risky clients with a low credit ability. Finally, previous experience shows that the control imposed by the central government when borrowing is concerned stimulates local governments to avoid these limitations through inventive out-of-budget schemes. Centralization of authorizations for borrowing does not have to increase the ability of the central government to control local responsibilities.

Direct access to capital markets, in opposition to this, offers a potential for a transparent connection, based on the market for development and on a stronger chance for strengthening strict budgetary limitations. The aspect with a growing importance is the one based on the market which contains market decentralization for financing the infrastructure. This includes participation of the private sector in financing and rendering government services, corporatism and differentiating rendering of services. In the countries with a limited local capital markets, market decentralization can enable access to international capital markets directly or through a service provider, and thus facilitates deepening capital markets.

Macro issues of moral hazard – the assumption of capital markets that borrowing of subnational governments is eventually supported by the central government – it can also be applied in case of direct borrowing from legal financial markets .

Managing such risks through a convenient regulatory frame with simultaneous market discipline in directing allocation of capital can be the most efficient mechanism for enabling subnational governments to access financial markets.

II. LEGAL LIMITS FOR MUNICIPAL INDEBTEDNESS

Purposeful legal limits is necessary in order to ensure that decentralized borrowing does not corrupt stimulus for giving loans by markets and excessive taking loans by subnational municipalities, excess which can eventually end up as a responsibility of central authorities.

Such limits require transparency if possible through better information systems. This includes standard accounting procedures of subnational municipalities and better public information about their responsibilities and capacity for paying back. However, better public information and better disclosure will not be enough when it comes to avoiding morally hazardous problems. Punishments should be imposed for excessive borrowing. For example, especially explicit bankruptcy procedures, a sort of financial committee members for control in the USA or a system of juridical enforcements in New Zealand, will probably have to be regulated by the law. The key aim in creating such processes is to ensure that the adopted bankruptcy mechanism which enables continuance of rendering basic services, even at a reduced rate, while management and financial reconstruction in procedure, otherwise the pressure for central rescue will be too big.

It is necessary to allow to subnational municipalities to have access to their revenue resources which can be pawned as collateral work in order to reduce possible moral hazard. Without such direct fiscal support , markets can perceive a loan from the capital market taken by subnational municipalities as an implicit support of the central government. Therefore mediation of the personal fiscal basis is a prerequisite for the access of subnational municipalities to the finances and for limiting the problem of moral hazard. The same importance within this context has the need to separate fiscal and financial systems when creating intevalid systems.

Indeed , we can formulate a hypothesis that the failure to separate fiscal and financial systems from borrowing authorization has led to macro instability in some countries – the network of implicit responsibilities suddenly appears as explicit budgetary responsibilities- preceding the process of decentralization itself.

For example, in Argentina, deficit in provincial municipalities was partly financed by provincial banks, many of which went bankrupt. As Wildasin pointed out, the policy of the central bank for management of these banks and absorption of their losses gave to provincial municipalities a mechanism for inflationary financing.

It also weakened stimuli for fiscal discipline at a provincial level. In Brazil, there are proofs showing that mild limitation of the budget between governmental levels can exist with the help of bank system in spite of a firm intergovernmental fiscal system. In reference to the situation in Brazil, Dillinger points out that huge budgetary limitations imposed to the fiscal side were avoided when the countries – consciously or not- used the financial system for obtaining funds.

Similarly, in China, a weak revenue basis imposed political pressure on the National Bank of China to offer a credit to lower levels of government. According to Lall and Hoffman , such „credit policy" can have negative effects on macroeconomic stability of prices and probably on fiscal discipline on a subnational level.
These examples suggest a cautious approach and the one which emphasizes the necessity of separating fiscal and financial system. Several mechanisms are possible. Firstly, independent national bank is the key element of a strict budgetary limitation. Secondly, where it is possible , public sector must leave the financial system.

It includes privatization of the banking system , but the sole privatization is not sufficient in order to apply separation. According to saving and credit crisis in the USA and elements of the recent financial crisis , private banks have to be supervised with a clear credit worthiness , regulatory level supervising level and nature of their accumulated responsibilities. Finally, one lesson from the international experience is clear: subnational public financial institutions are not desirable. Stimuli given to subnational municipalities to misuse their relations with their financial institutions at the cost of macro-stability, are too big.

Market decentralization can also offer an interesting mechanism for reducing moral hazard. Privatization of public infrastructure can enable the application of bankruptcy regulations in the private sector and to allow other companies within the private sector to offer property in case of financial difficulties , and that option is not possible for public property. However, in order to implement such an option, the governments have to secure that there are several suppliers in each sector. Private participation creates possibilities for evaluation of financial justice besides the debt which creates a stimulus for „the capital for monitoring the debt " which is not available in public financial systems .

Besides, separating can reduce the size of the entity in question and thus avoids the syndrome of „too big to succeed ", which is often connected with the rescue. Finally, secret channels for creating financial responsibilities must be supervised and , where possible, closed. Especially,institution of laws has to make sure that using pension funds or using subnational corporations for taking loans on behalf of subnational municipalities are prevented or to include them explicitly into subnational debt. Besides that, balanced budgetary requirements of subnational municipalities can secure that current accounts will be balanced till the end of every fiscal year , so that borrowing with the purpose of coinciding with flows of revenues and expenditure does not lead to financing current account deficiencies in time.

Generally, a combined usage of information systems of accessing personal revenues , public institution of laws , laws on bankruptcy and market decentralization offer an overall institutional stimulus for a strict budgetary limitation at all government levels and allows decentralization of borrowing .

After considering this, the question is should foreign loans be allowed? Separating direct access that subnational municipalities have to international capital markets , complicates further separation of the macroeconomic management , liberalization of the general capital account and natural regime of foreign currency exchange. This overall context will determine should direct borrowing at international markets be allowed to subnational municipalities. Considering the restricted consensus about this question , it seems that there is a tendency to attach a direct access of subnational municipalities to international markets. Anyway, the questions concerning regulatory limits for decentralized borrowing refer both to local and foreign loans.

III. CONCLUSION: EXECUTION OF FINANCIAL DECENTRALIZATION

Financial decentralization – allowing subnational municipalities to access capital markets directly – is an important part of devolution of fiscal authorization to regional and local authorities. If correctly elaborated, decentralization of borrowing authorization can add to advantages in efficiency and management which are expected from fiscal decentralization. Therefore, implementation of financial decentralization should get an equal advantage in creating intergovernmental fiscal relations. However, as suggested here, in order to implement financial decentralization, regulatory limits have to be well organized. This warning does not imply the scenario all or nothing: gradual and asymmetrical approach can be adopted in order to implement financial decentralization. Policies can contain the sequence of fiscal decentralization which precede giving the authorization to subnational municipalities to access capital markets; enabling larger urban centers, which present themselves in reference to fiscal funds and management capacity from other local municipalities, to have a faster access to financial markets and may be even a controlled and restricted access to foreign markets; implementation of market decentralization as a step to financial decentralization ; and replacing implicit transfer of funds with the help of public financial institutions by explicit fiscal transfers. Generally, it is a challenge to create regulatory limits for fiscal decentralization and its implementation processes. Discussion on whether fiscal decentralization is good or bad can be disputable in the era of new local capital markets and a strong political inducement in many countries to decentralize authorities to subnational municipalities.

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