

Subnational Insolvency:
Cross-Country Experiences and Lessons

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Abstract

Subnational insolvency is a reoccurring event in development, as demonstrated by historical and modern episodes of subnational defaults in both developed and developing countries. Insolvency procedures become more important as countries decentralize expenditure, taxation, and borrowing, and broaden subnational credit markets. As the first cross-country survey of procedures to resolve subnational financial distress, this paper has particular relevance for decentralizing countries.

The authors explain central features and variations of subnational insolvency mechanisms across countries.

They identify judicial, administrative, and hybrid procedures, and show how entry point and political factors drive their design. Like private insolvency law, subnational insolvency procedures predictably allocate default risk, while providing breathing space for orderly debt restructuring and fiscal adjustment. Policymakers' desire to mitigate the tension between creditor rights and the need to maintain essential public services, to strengthen ex ante fiscal rules, and to harden subnational budget constraints are motivations specific to the public sector.

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1. Introduction

Three factors have propelled the growth in subnational capital markets in developing countries since the 1990s and will drive their future growth.² First, decentralization in many developing countries has given subnational governments significant spending responsibilities and taxation power and the capacity to incur debt. Second, large infrastructure projects in developing countries increasingly tap into capital markets for financing.³ Third, liquidity and growing mobility of international capital across national borders have lowered the cost of borrowing and thereby strengthened financing opportunities for infrastructure.⁴

This growth in subnational credit markets displays two distinct features. First, subnational bonds have become an increasingly important source of funding competing with traditional bank finance. Second, private capital has emerged to play an important role in subnational finance in countries such as Hungary, Mexico, Poland, Romania, and South Africa, and a dominant role in Russia, though public institutions continue to dominate subnational lending in a number of countries such as Brazil and India.

Yet, growth in subnational bond markets in developing countries has not been steady. Annual volume gradually increased from US\$5.7 billion in 1992 to US\$22.2 billion in 1995, to be followed by a general downward trend to US\$3.5 billion in 2001.⁵ Since 2001, growth in subnational bond markets has picked up in emerging markets such as Russia, Mexico, Poland, and Romania.⁶

Notwithstanding the recent revival, the availability of credits to subnational governments remains limited to top-tier subnational governments. By developed country standards, the market was small even at its growth peak. In the United States, US\$400 billion subnational bonds are issued per year on average.⁷ In contrast, 19 Mexican subnationals issued US\$1.44 billion bonds over the period 2001-2005. In Colombia, only the capital Bogota accessed the capital market from 2003-2006.

² The term subnational refers to all tiers of government and public entities below the federal or central government. Subnational entities include states/provinces, counties, cities, towns, public utility companies, school districts and other special purpose government entities which have the capacity to incur debt. The term subnational capital market refers to both the banking system and the bond markets.

³ Infrastructure networks benefit future generations as well; thus sound public policy demands that the financing of infrastructure networks be shared by future generations through matching repayment of debt financing with maturity of assets.

⁴ See Eddy and Richter (2000), at 9-10 on international capital financing of subnationals.

⁵ Subnational bonds issued outside Canada, Europe and the United States were \$5.7 billion in 1992, \$9.4 billion in 1993, \$12 billion in 1994, \$22.2 billion in 1995, \$12.7 billion in 1996, \$4.3 billion in 1997, \$4.4 billion in 1998, \$1.5 billion in 1999, \$6.4 billion in 2000, \$3.5 billion in 2001. The 1990s therefore saw huge positive, but also strongly negative growth rates (Source: Thompson Financial Securities Data).

⁶ The Russia sub-sovereign bond market has grown vigorously since its re-emergence in 2001 and has now become the largest sub-sovereign market among emerging economies with US\$5.6 billion bonds outstanding as of June 2006 (Noel, Kantur, Krasnov, and Rutledge, 2006).

⁷ In January 1, 2006, subnational bonds outstanding reached US\$2.26 trillion. This represents close to 10 percent of the US domestic bond market and 26 percent of all US public sector bonds (authors calculated based on World Bank 2006). The figure of US\$400 billion issues is from Petersen (2005).

Subnational bond markets in emerging economies remain thin for a number of reasons. As highlighted by the World Development Report (2000), subnational debt is “one of the thorniest issues for decentralization, with many potential pitfalls.” Obstacles range from incomplete decentralization, which limits a subnational’s own-revenue capacity, to a lack of transparency in fiscal accounts, which makes it difficult to evaluate subnational creditworthiness. Furthermore, several emerging economies have restricted subnational borrowing after experiencing subnational or national debt crises.⁸ Such tightening is part of broader ongoing efforts to develop a sound regulatory framework to tackle subnational debt crises.

Several major emerging markets experienced subnational debt crises in the 1990s. Newly decentralized countries face similar risks. To many observers run-away provincial debt in the Provinces of Mendoza and Buenos Aires was a major factor behind Argentina’s sovereign debt default in 2001. Brazil experienced three subnational debt crises in the 1980s and 1990s. In India, many states experienced fiscal stress in the late 1990s to the early 2000s, with a rapid increase in fiscal deficits, debt and contingent liabilities. The 1995 Tequila crisis in Mexico exposed the vulnerability of subnational debt to the peso devaluation and led many Mexican subnationals into debt crises. In Russia at least 57 out of 89 regional governments defaulted over 1998 - 2001.

Subnational insolvency is a reoccurring event in development.⁹ In 1842, eight US States and the Territory of Florida defaulted on their debt and three other States were in perilous financial condition (Wallis, 2004). During the Great Depression, 4,770 local governments defaulted on US\$2.85 billion of debt. By 1933 over 16% of the U.S. municipal market was in default (Maco, 2000). As capital markets and their regulatory framework matured, defaults by US subnationals became less frequent. Yet crises continue to occur. Prominent examples include the fiscal crisis of New York City in 1975, the default on US\$2.25 billion in bonds of the Washington Public Power Supply System in 1983, and the bankruptcy of Orange County in 1994 and the District of Columbia in 1995.¹⁰ There have also been cases of local government financial distress in Japan and Western European countries.¹¹

The perils of subnational insolvency are serious. At a minimum, provision of local public goods and services may be severely impaired. When New York City was in fiscal crisis in 1975, essential services such as fire protection, police patrols, garbage collection, and schools were cut back. Maintenance on bridges and roads was postponed. Many capital

⁸ For a survey of recent developments in controlling subnational borrowing in several emerging economies, see Liu and Waibel (2006).

⁹ This paper uses insolvency and bankruptcy interchangeably. Both refer to the financial condition of a particular subnational entity. We add “mechanism” or “procedure” to refer to the legal framework.

¹⁰ Cf. District of Columbia Financial Responsibility and Management Assistance Act (Public Law 104-8), April 17, 1995. Spiotto (1984) lists 6,195 defaults on US municipal bonds from 1839 to 1969.

¹¹ Moody’s (2002) eight subnational default studies covering France, Italy, Switzerland, the UK, Argentina, Brazil, Mexico and Russia provide quantitative and qualitative evidence of a limited number of documented defaults and numerous cases of non-payment and distressed exchanges. Sars (1999) provides evidence on Western Europe, at 1-2 (“As illustrated by these cases, local governments sometimes do face financial distress despite the strength and stability of the underlying local government system”). For a discussion on Japan local debt, see Schwarcz (2002).

projects were delayed or cancelled.¹² Beyond local service delivery, systemic subnational insolvency may impede the growth of subnational capital markets, curtail fiscal space for infrastructure financing, and threaten macroeconomic and financial stability.

These perils have led many developing countries to search for the “right” subnational borrowing framework (Liu and Waibel, 2005; Webb 2005). However, cross-country experiences suggest that ex-ante subnational borrowing regulations need to be complemented by ex-post mechanisms for insolvency resolution. Ex-ante limits on subnational fiscal indicators (such as balanced budget rules, limits on the ratio of debt over gross subnational domestic product (GSDP), and debt-service ratios) are not sufficient.¹³ Many countries lack robust mechanisms to resolve subnational financial distress efficiently and fairly.¹⁴

Several arguments favor ex-post subnational insolvency mechanisms. First, insolvency mechanisms discipline debtors and creditors, structure negotiation and encourage collective action.¹⁵ Second, insolvent subnationals are put back on a sustainable fiscal path to guarantee public service delivery. Third, restoring subnational sustainability serves creditors collectively. Fourth, protecting creditor rights helps nurture embryonic capital markets. Fifth, clarity in default helps improve creditworthiness of subnational entities and enable subnational entities to reenter the capital market for financing infrastructure. A well-designed workout procedure results in equitable debt collection for creditors, while lowering the costs of borrowing and creating fiscal space for infrastructure investment.

This paper surveys mechanisms for the resolution of subnational insolvency in selected countries. It fleshes out basic concepts and highlights transferable features. Focusing on the experiences of Brazil, Bulgaria, Hungary, Romania, South Africa and the United States, we draw lessons for tailoring subnational insolvency mechanisms to country-specific circumstances. Although there are individual country case studies,¹⁶ the literature lacks a cross-country survey. This paper seeks to fill this gap. Comparison of country experiences draws out core design issues concerning subnational insolvency

¹² Bailey (1984).

¹³ Interestingly, Germany, whose subnationals have traditionally relied on bank financing, is actively exploring a subnational workout procedure because of the difficult financial position of many municipalities. See Paulus (2003), and Wissenschaftlicher Beirat beim Bundesministerium für Finanzen (2005). The German Constitutional Court’s judgment of October 19, 2006, denying that Berlin is in a situation of extreme financial distress, will provide additional impetus for the development of subnational insolvency procedures in German (BVerfG, 2 BvF 3/03, Oct19 2006, available online. http://www.bverfg.de/entscheidungen/fs20061019_2bvf000303.html).

¹⁴ The United Nations Commission on International Trade Law (UNCITRAL) Guide on Insolvency (2004), which lays down recommended principles for corporate insolvency law, does not cover public entities (states and subnationals). Due to a lack of international consensus, the guide has so far refrained from recommending the introduction of insolvency procedures for municipalities. In Europe, the Council of Europe recommended already in 1996: “The competent authorities should clearly state the consequences in the event of local authority insolvency.”

¹⁵ For insolvency law exercising as a disciplining function, see Paulus (2006).

¹⁶ For example, McConnell and Picker on the United States (1993), Jokay, Szepesi, and Szmertana on Hungary (2004), and Glasser on South Africa (2005). Schwarcz (2002) compares the U.S. and Japan.

mechanisms and demonstrates how the design of key elements of an insolvency mechanism varies across countries. The paper does not prescribe how such mechanisms should be transferred to different institutional settings.

The paper is structured as follows. Section 2 examines the events triggering the development of subnational insolvency mechanisms in various countries. This motivation is country-specific and shapes design. Section 3 explores the key issues in designing insolvency mechanisms, encapsulated in the trade-off between protecting creditor's contractual rights and maintaining minimum public services. Section 4 discusses the central elements of insolvency procedures: triggering, filing, collective enforcement, fiscal adjustment, and debt restructuring. Section 5 presents concluding remarks and draws policy lessons for other developing countries.

2. Why Regulate Subnational Insolvency?

Sustaining healthy growth in subnational credit markets requires a transparent framework for allocating risks and losses in default. The first purpose of the framework is to credibly signal to lenders that debt restructurings will be predictable and equitable and signal to borrowers that irresponsible fiscal behavior entails consequences. The second aim is to maintain minimum essential public services such as law and order, fire protection, and water and sanitation during a subnational government's debt restructuring and fiscal adjustment.

While sharing these broad objectives, a country's political, economic, legal and historical context in combination with unique triggers results in country-specific motivations. These differences affect the entry point for reform, the framework's design and its relation to subnational borrowing legislation. Despite important differences, individual experiences are valuable to other countries as they consider their policy options. The following section summarizes experiences in the United States, South Africa, Hungary, Brazil, and three other Central and Eastern European Countries.

2.1 United States

In response to widespread municipal defaults during the Great Depression, the US Congress adopted a municipal insolvency law in 1937.¹⁷ Today, this Act is known as Chapter 9 of the US Bankruptcy Act (Chapter 9). The primary aim of this legislation was to deal with the holdout problem. Individual creditors often demanded preferential treatment and threatened to derail debt restructurings voluntarily negotiated between a majority of creditors and the subnational debtor.

¹⁷ Bankruptcy Act of 1938 ("Chandler Act"), 50 Stat. 654 (1937), amending the 1898 US Bankruptcy Act. The 1938 Act was the first legislation for municipal bankruptcy in the world, even though other countries have contemplated the introduction of similar mechanisms earlier (e.g., Switzerland in the second half of the 19th century, see Meili (1885)). In 1934, the US Supreme Court had declared a previous version of this legislation unconstitutional, see *Ashton v. Cameron County Water Improvement District No. One*, 298 U.S. 513.

The enactment of the municipal bankruptcy statute in 1937 was one more step in a series of regulatory reforms on subnational borrowing since the first subnational debt crisis in the early 1840s. After the 1840s crisis, twelve states adopted new constitutions, and eleven of the twelve required that state legislature adopt new procedures for authorizing state borrowing. Other reforms at the time included opening access for infrastructure finance and development and eliminating taxless finance.¹⁸

Following the reform in the 1840s and 1850s, various states also reformed their municipal borrowing regulations. One important concern was debt service in the event of default. In theory, the main remedy was one without analogue in private bankruptcy; the issuance of a writ of mandamus imposing new taxes.¹⁹ The 1870 Illinois Constitution, for example, obliged the general assembly to tax all property within the limits of municipality for debt payment. In theory, creditors could thus use the mandamus to compel municipal officers to service debt obligations; in practice, this remedy was largely ineffective.²⁰

The Great Depression, when subnational financial distress was prevalent, revealed the practical drawbacks of the mandamus. Taxes were then already at historical highs. In such circumstances, raising taxes will often lead to the flight of higher income taxpayers and businesses. Higher revenue is unlikely. The mandamus is useful for enforcing unpaid discrete obligations; it is ineffective if the subnational is unable to pay. Moreover, courts often regarded the mandamus as discretionary, and when it was ordered, municipal officers took various actions to escape the court's order. In extreme cases, they resigned.²¹

As an individual creditor action, mandamus cannot solve the collective action problem. When widespread defaults occur, uncoordinated enforcement by individual creditors is impracticable, costly and potentially harmful to the interests of a majority of creditors. The inability to compel holdouts to cooperate in a negotiated compromise motivated the passage of Chapter 9 of the U.S. Bankruptcy Code.²²

Chapter 9 is a debt restructuring mechanism for political subdivisions and agencies of U.S. states.²³ It provides the procedural machinery whereby a debt restructuring plan acceptable to a majority of creditors can become binding on a dissenting minority. Only debtors may file for Chapter 9. States must give specific authorization. This is one instance of how the U.S. Constitution reserves control over municipalities to states. Moreover, federal courts may not exercise jurisdiction over policy choices and budget priorities of the debtor.

¹⁸ See Wallis (2004).

¹⁹ The mandamus is a court order obliging public officials to take a certain course of action.

²⁰ For a more detailed and excellent account on the mandamus and its implications for the motivation for Chapter 9, see McConnell and Picker (1993).

²¹ McConnell and Picker (1993).

²² Chapter 9 of the U.S. Bankruptcy Code applies to municipalities; Chapter 13 applies to private bankruptcy. See McConnell and Picker (1993) for a detailed discussion on the motivation for Chapter 9.

²³ Several of its central elements are explained in more details in Section 4. The annex provides an overview of key provisions.

Chapter 9 is not the only subnational insolvency mechanism in the United States. Many states have adopted their own frameworks for dealing with municipal financial distress, for two reasons. First, municipalities are political subdivisions of the states and thus creatures of the states. Second, state consent is a precondition for municipalities to file for Chapter 9 in federal court. There is no uniform approach across states. 21 of the 50 states give blanket consent, three states attach important conditions, and 27 states grant permission on a case by case basis.²⁴

When New York City went into financial crisis in 1975, then the largest municipal fiscal crisis since the Great Depression, the state of New York intervened directly.²⁵ The state took over the city's financial management through the Municipal Assistance Corporation (MAC) in June 1975. MAC was a public benefit corporation of the state of New York to help the city restructure its glut of short-term debts.²⁶ Three months later the state established the even more powerful Emergency Financial Control Board (EFCB) for New York City.²⁷

The EFCB took over fiscal management of the city, overseeing the creation and execution of a three-year fiscal adjustment plan leading to balanced budgets. Difficult adjustments included dismissing 60,000 public servants, increasing taxes and fees, and curtailing borrowing. The debt was restructured and transparency in accounting, auditing, and financial reporting was prescribed.

Created by the state legislature, the EFCB had the legitimacy and broad authority to address the root cause of fiscal decline. Had New York City instead petitioned for bankruptcy protection under Chapter 9, the federal court, unlike the EFCB, could not have interfered so strongly in the fiscal affairs of the city. Unlike off-the-shelf bankruptcy protection, the state here decided to use an ad-hoc approach tailored to the specific circumstances of the city. Among the few areas where the EFCB could not interfere were setting budget priorities, which remain the prerogative of elected city officials, and the right of employees to bargain collectively.²⁸

²⁴ See Laughlin (2005). The three States with conditions are Pennsylvania, North Carolina, and most prominently, New York.

²⁵ New York City never actually filed for Chapter 9. City officials were aware that the U.S. Bankruptcy Code required written consent of creditors holding 51% of the debt. Yet New York did not know the identity of many creditors, in particular its bondholders. The US Bankruptcy Act of 1978 amended this requirement. Instead of explicit consent, Section 109 (c) 5 (c) allows submission of a plan if the debtor is "unable to negotiate with creditors because such negotiations are impracticable." For a detailed explanation why this requirement was the primary obstacle to use of Chapter 9 in New York's case, see Comment, "Reform of Creditor Participation Procedures in Municipal Bankruptcy", 85 Yale Law Journal 423, at 424-425. The Congress approved a \$2.3 billion emergency loan to New York city on December 6, 1975.

²⁶ The MAC was created by the State Municipal Assistance Corporation Act and other enabling legislation.

²⁷ The state asserted its power by declaring an emergency under the Financial Emergency Act. The Act created the EFCB and adopted other financial emergency measures to prevent the city from defaulting on its bonds.

²⁸ While the EFCB never explicitly violated these limits, the impacts of its policies did (Bailey, 1984).

While the U.S. municipal insolvency framework offers a valuable reference for other countries, the framework itself cannot be copied without care. Chapter 9 was conceived with the narrow objective of resolving the holdout problem, against the background of a mature intergovernmental fiscal system and a market-oriented financial system. In countries where the intergovernmental systems are still evolving and/or lending to subnational governments is dominated by a few public institutions, the development of a subnational insolvency mechanism must be sequenced with other reforms. The unique federal structure of the United States also profoundly influences the specific design of Chapter 9, for example with respect to the role of federal courts in the debt adjustment plan of an insolvent municipality. As the insolvency mechanism needs to define the respective role of different branches and tiers of the government, a country's political and economic history plays a key role in shaping the design of the insolvency mechanism.

Finally, for states which do not give blanket permission for their municipalities to seek the shield of the federal Chapter 9, each state chooses its own way of resolving municipal insolvency. The example of New York City serves as an illustrative example but not as the standard model.

2.2 South Africa

South Africa's motivation for enacting a municipal insolvency framework differed from that of the United States. While Chapter 9's focus is the holdout problem, within a mature intergovernmental fiscal system and a market-oriented financial system, South Africa developed subnational insolvency legislation within the fundamental changes in the country's political structure and municipal system.

During apartheid, only white local governments were creditworthy (black local governments were not) and could, therefore, raise funds from the capital markets directly, based on their steady local revenues and implied central guarantees. Defaults were absent, and legal remedies were underdeveloped. Black communities relied on central transfers and on-lending from a public financial institution guaranteed by the central government.²⁹

After the fall of apartheid, several developments affected the municipal borrowing landscape. The new decentralized constitution ended the guarantee of local debt. Municipal boundaries were redrawn in 1995 to combine poor black urban communities with wealthier white urban communities. In 2000, white and black local governments were formally combined. The 283 newly formed municipalities were busy dealing with a range of priorities more immediate than borrowing.

These developments also brought uncertainty regarding the fiscal health of amalgamated municipalities, including apartheid legacy debt. Prolonged financial troubles of some municipalities also increased the uncertainties perceived by private lenders.³⁰ The intergovernmental fiscal transfers provided more funding than many municipalities could

²⁹ Ahmad (2002).

³⁰ Examples are Butterworth, Noupoort, Ogies, Stilfontein, Tweeling, and Viljoenskronn (Glasser, 2005).

absorb, thus reducing the need to borrow.³¹ Furthermore, the Minister of Local Government is legally entitled to cap municipal tariffs, which private lenders perceived as a threat (this power has not been invoked to date).

Notwithstanding the factors impacting borrowing demand, the government wished to develop a competitive private capital market for municipal finance. The government's White Paper on Local Government (1998) stressed the importance of private investments in the municipal bond market. However, from 1997 to 2000, private lending remained stagnant, and the expansion in municipal debt was driven by growth in public sector lending particularly by the Development Bank of South Africa.³²

The government was then developing a unifying framework to govern the finances of amalgamated municipalities. Insolvency procedures were thus viewed as an essential part of the framework. To private creditors, ad hoc negotiations and debt restructuring were insufficiently insulated from political pressure. Government-owned lenders are able to lend in an inadequate policy environment. In fact, such an environment gives such a lender a competitive advantage over the private sector.³³ Clarity about the rights and remedies of private lenders was viewed by the government as important to broaden and diversify the municipal finance market.³⁴

South Africa went through a lengthy consultation process to develop the subnational insolvency procedures, as interests of different parties – the treasury, lenders, and municipal government – had to be synthesized. The process may also require modifying the existing institutional structure. At the heart of the insolvency procedures are debt and fiscal adjustment. However, under the old section 139 of the Constitution (1995-2002), few remedies existed to effect debt and fiscal adjustments for a financially-troubled local government. Budgets, spending and taxes were under the purview of the local legislature. Intervention into local government affairs was limited to cases where an “executive obligation” was not fulfilled. The Province could only issue a directive to the council or assume responsibility for the obligation.

Two constitutional amendments paved the way for a municipal insolvency mechanism.³⁵ The amendments make the debt issued by the current local council valid beyond the term of the council, and expand the power of other spheres of government to intervene in legislative aspects, such as the budget or the imposition of taxes. The Municipal Finance Management Act, enacted in 2003, contains a new framework for municipal finance and borrowing. Chapter 13 of the Act spells out detailed criteria for interventions and recovery plans, specifies the role of higher-level governments and courts in the insolvency mechanism, and outlines the fiscal and debt adjustment process. Only courts can stay debt payments and discharge debt obligations.

³¹ These transfers consist of the constitutionally mandated "equitable share" unconditional grant to all municipalities and the conditional Municipal Infrastructure Grant both of which are calculated by formulae.

³² South Africa National Treasury (2001), at 192-193.

³³ The Development Bank of South Africa has provided lending at sub-market rates for many years and greatly distorted the municipal finance market.

³⁴ South Africa National Treasury (2001), at 192-193.

³⁵ South Africa Act No 34 of 2001 and Act No 3 2003.

Intervention is potentially strong and can involve substantial loss of local political autonomy.³⁶ Modalities of interventions include the issuance of directives, full loss of municipal autonomy in financial matters under mandatory interventions, and dissolution of the Municipal Council in extreme circumstances. Primary responsibility lies with the provincial government, but the central government may intervene when the province is unable or unwilling to act. Compared to Hungary, where the court-appointed financial trustee takes the center stage, in South Africa the provincial executive plays an important role.

The South African case demonstrates the complexity of subnational borrowing and insolvency legislation and the path-dependency of reforms. It shows that insolvency procedures are part of broader institutional reforms, and the procedures alone do not generate demands for market borrowing; the size of South Africa's municipal borrowing market remains small.³⁷ It also illustrates the importance of building political consensus among various interest groups. Broad support may require concerted efforts over a number of years. South Africa took two years to develop the basic policy framework (1998-2000), another year for the cabinet approval (2001), followed by two years of parliamentary debate on the constitutional amendments and on the Municipal Finance and Management Act (2001-2003).

2.3 Hungary

If South Africa's motivation for developing a regulatory framework for subnational insolvency was to revive private lending to municipal governments, Hungary acted on two different motivations in the mid-1990s.³⁸ The first was to discipline lenders. Lending by public banks was viewed as indiscriminate and imprudent, without proper evaluation of their creditworthiness. The lack of credit differentiation was attributed to the assumed central government guarantee for subnational debt and potential problems associated with public sector lending. The second motivation rose from the deteriorating financial performances of local governments which foreshadowed contingent state liabilities. In financial distress, borrowers and lenders were expected to lobby strongly for bailouts.

The 1990 Act on Local Government granted Hungary's local governments independence in financial management. Municipalities had unfettered freedom to manage their finances and started to borrow for commercial activities, thus increasing the risks of insolvency. The macroeconomic deterioration in 1995 exposed the seriousness of subnational financial distress. Furthermore, municipalities began to borrow long-term to finance short-term operating deficits. Several local governments successfully lobbied for one-time grants from the central government.³⁹ This threatened to set a bailout precedent, raising concerns of adverse incentives for local governments and for creditors. Representatives of several commercial banks argued that these loans were for the public benefit and deserved bailout by the state.

³⁶ There are differing views within South Africa whether the potential interventions go too far.

³⁷ This is an interesting topic for future research: given the clear legal framework for municipal finance, borrowing remains small. What are possible explanations?

³⁸ This section is largely based on Jokay, Szepesi, and Szmertana (2004).

³⁹ For example Bakonszeg, Nagocs, Batorliget, and Paty (see Jokay, Szepesi, and Szmertana, 2004).

Several options were debated at the time. The first option was for the central government to credibly adopt a no-bailout policy. The second option was to impose restrictions on borrowing and strengthen monitoring and enforcement. The third option was to rely on informal restructuring negotiations between major financial institutions and local governments. The Hungarian government opted for an innovative subnational insolvency mechanism.

Even though informal negotiations may lead to debt adjustment, they could not formalize debt restructuring procedures, the transparency and predictability of which are central to an effective subnational insolvency mechanism. In the end, maintaining essential public services, protecting debtors, creditors and the state budget, while clarifying the consequences of defaults justified a debt adjustment law. The Law on Municipal Debt Adjustment (Law XXV) was approved by the Hungarian Parliament in March 1996 by an overwhelming majority.⁴⁰

Hungary differs from South Africa in one important way, namely the central role of courts in fiscal and debt adjustment for insolvent local governments in Hungary. In South Africa, the court's role is limited. It can grant an eventual debt discharge, but it is the provinces and the central government which directly influence fiscal and debt adjustments of financially-troubled local governments. In Hungary, courts play the central role in the insolvency procedure.

It is worth noting that the debt adjustment legislation is only a part of the system influencing fiscal behavior of subnational governments. It cannot compensate for inadequacies in the design of overall intergovernmental fiscal relations. While the legislation is an important element, it is only a necessary but not sufficient for improving local governance. Too many small municipalities with diffuse functions and absence of clear own-source revenues would fundamentally affect the fiscal behavior of local governments and their approach to accessing capital markets.

2.4 Brazil

Brazil has opted for an administrative approach to subnational insolvency, in contrast to the United States, South Africa, and Hungary where the role of the judiciary is more pronounced. The precise role of courts differs in the three countries. Since the 1980s, Brazil has experienced three state debt crises (Ter-Minassian (1997) and Dillinger (2002)).⁴¹ The complex structure of fiscal federalism caused a lack of fiscal co-responsibility and the absence of hard budget constraints by lower levels of government. There was no control of subnational debt.

Brazil always had statutory controls on subnational borrowing—controls on new borrowing and on the total stock of debt, expressed as percentages of revenue. But the regulations had loopholes. For example, borrowing from the national housing bank was

⁴⁰ Section 4 of the paper discusses key elements of the debt adjustment law, such as initiation of filing and debt negotiation agreement.

⁴¹ Unless otherwise noted, the discussion on Brazil builds on Ter-Minassian (1997) and Dillinger (2002).

exempt for a while. And local governments had been creative at exploiting the loopholes. In the spectacular debt crisis of the 1990s, state governments simply stopped servicing their debt, allowing interest to capitalize to immense proportions. On several occasions, the federal government bailed out states and municipalities. From the late 1980s to 1990s, the federal government restructured subnational debt three times.

In the subnational debt crises in the 1980s and the early 1990s, the central government bailed out insolvent subnational entities. The first subnational debt crisis was a legacy of the international debt crisis of the 1980s, when states, along with the federal government, ceased servicing their debt to foreign creditors. After the federal government reached agreement with the creditors, in 1989, the federal government consolidated accumulated state and municipal arrears and remaining principal into a single debt to the federal government. US\$19 billion was rescheduled. The second crisis involved debt owed by the states to federal financial institutions. In 1993, the federal government refinanced debt amounting to US\$28 billion. The third and largest debt crisis was resolved through the conditional bailout of the federal government in 1997. The federal government restructured the states' debt, equivalent to 11.5 percent of GDP. However, the central government's restructuring was conditioned on states fiscal reforms. This adjustment program tackled the root causes of fiscal insolvency. It aimed at instilling fiscal transparency and essentially imposed a fiscal and debt adjustment package.

With the first two debt workouts, the federal government tightened regulations on state borrowing. These efforts turned out to be insufficient. The 1997 debt workout was conditioned upon each state's compliance with a fiscal and structural reform program. The motivation for the conditional bailout was to resolve the moral hazard associated with unconditional bailouts. In exchange for the rescue package, the federal government negotiated agreements with 25 States in 1997 and 1998.⁴² These agreements were sanctioned by Law 9496 of September 1997.

Law 9496 established a comprehensive list of fiscal targets: a debt/revenue ratio, primary balance, limits on personnel spending, own-source revenue growth, investment ceilings, and a list of state enterprises to be privatized or concessioned. Each State had to agree to such targets in exchange for financial relief. Crucially, the debt adjustment agreement collateralized resources for debt service and threatened withholding central government transfers in case of breach. Subsequent Senate Resolution No. 78, 1999 imposed fixed ceilings on new borrowing, debt servicing, and the stock of debt. All these controls were strengthened by the 2000 Fiscal Responsibility Law which consolidated many restrictions and regulations into one unifying framework.⁴³

2.5 Albania, Bulgaria, and Romania

A group of Central and Eastern European Countries – Albania, Bulgaria, and Romania – represents another set of interesting cases. These countries see a subnational borrowing

⁴² Only two States (Tocantins and Amapá) did not have any bonded debt, and hence did not participate in the refinancing agreements.

⁴³ For a detailed survey of the Brazilian subnational borrowing legislations, see Liu and Waibel (2005).

framework, including an insolvency mechanism, as a crucial element to underpin fiscal decentralization and their fledgling subnational debt markets. Aspiration to European Union membership provides added impetus for such reforms.⁴⁴

In Bulgaria, only the capital Sofia has issued international bonds.⁴⁵ The near absence of a subnational borrowing market is commonly explained by an ambiguous borrowing framework, a lack of local fiscal autonomy, weak local finances, and a fragile banking system.⁴⁶ In June 2005, legislation for subnational borrowing was approved. Legislative process for municipal insolvency regulation is ongoing. Bulgaria is an example of a country looking at such a mechanism before signs of trouble appear. The lending community favors an insolvency mechanism. Bulgaria, by deciding to look into the merits of such a policy early, is able to start with a clean slate. However, the development of a regulatory framework for subnational borrowing needs to go hand in hand with improving the intergovernmental fiscal system, granting subnationals greater fiscal autonomy, and reforming the financial markets.

Romania's capital market for subnational borrowing has been developing at a faster pace than Bulgaria's. Subnational debt is evenly divided between loans and bonds, with about 30 bond issues and 30 bank loans between 2002 and 2005.⁴⁷ So far, lending has been mostly limited to top-tier municipalities, small-scale projects and 3-5 year maturities for most offerings. Recently maturities have been extended to up to 10 to 20 years for a few issues. To tap European Union's accession financing, subnational borrowing needs to expand in size and spread to more municipalities.

To capital markets, the limited growth in capital markets is due to uncertainty on the impact of default by a municipality. Lenders are unable to assess their rights and remedies. Lenders worry about political influence and unequal treatment of subnational governments. They call for clarity on available remedies against defaulting municipalities. In corporate bankruptcy, Romania has already accumulated substantial experience over the past few years. In 2006, Romania enacted Law 273/2006 on Local Public Finance, with articles 74 and 75 setting up a framework for local government bankruptcy. The implementation of insolvency mechanism requires additional legislation to specify the procedures.

A similar effort is under way in Albania where the subnational debt market is just starting to develop. A comprehensive legislative framework for borrowing is under consideration.

⁴⁴ Cf. also the Council of Europe (1996) recommendation: "The competent authorities should clearly state the consequences in the event of local authority insolvency."

⁴⁵ The economic upheavals and fiscal pressures of the early 1990s led to widespread deferral and cancellation of capital projects and infrastructure in all Bulgarian cities. Since then, Sofia has managed its budget prudently. As a capital city, however, it has unique advantages. Relatively debt free, the city has successfully entered the international bond market. Sofia issued a 50 million Euro bond on May 12, 1999 (Ellis and Ionkova, 2004).

⁴⁶ Ellis and Ionkova (2004).

⁴⁷ Municipal bond issues are underwritten by banks and priced before being issued. This combined with a very low activity in the secondary market (banks usually hold the bonds until maturity) means that bond issues are actually very similar to loans.

The government is interested in establishing an insolvency framework early on based on the experiences of Hungary and other countries. Adoption of Albania's subnational insolvency statute is imminent.

3. Designing Subnational Insolvency Mechanisms

Notwithstanding different motivations, experiences from Brazil, Hungary, South Africa, and the United States reveal several key issues in designing a sound regulatory framework for insolvency. These issues are: balancing the tension between the contractual rights of creditors and the need for maintaining public services in the event of financial distress and default, a hard budget constraint for subnational entities, a credible no-bailout promise by the central government, clear and predictable rules to anchor expectations, and burden-sharing between the subnational entity and creditors. Countries also face a basic choice between a judicial, administrative or a hybrid approach. Real-life mechanisms differ substantially, and the chosen design is in large part dependent on country-specific circumstances.

3.1 Comparing public and private corporate insolvency

Insolvency of subnationals is qualitatively different from private corporate entities. First, subnational governments provide public goods in fulfillment of mandated responsibilities. Second, compared to corporations, creditors' remedies against defaulting subnationals are narrower, leading to greater moral hazard (strategic defaults). Third, while a corporation is able to self-dissolve, this route is barred for subnational governments. Fourth, the typical subnational has some taxation power.

The core difference between the insolvency of private corporations and subnational governments is the public nature of the services provided by subnational governments. This core difference also explains the basic tension between protecting creditor rights and maintaining essential public services. Creditor rights are central to the development of capital markets; at the same time, providing essential public services such as police, drinking water, and fire protection is the basic role of the government.⁴⁸ In this sense, the satisfaction of creditor claims is subject to an absolute functional limit: the protection of the core functions of the subnational entity.

In the event of private corporate bankruptcy, all assets of the corporation are potentially subject to attachment.⁴⁹ By contrast, the ability of creditors to attach assets of subnational governments is greatly restrained in many countries. Due to their public good nature, some municipal assets have little or no market value. The reasons for granting subnationals partial immunity from attachment are concerns over potential disruption of

⁴⁸ A narrow view would include only a limited range of public services such as police, drinking water, and fire protection. The scope of protected essential services is likely to differ significantly across countries.

⁴⁹ This rule of thumb applies only to corporations. For individuals, a long list of goods is typically exempted from attachment. Each US state, for example, sets a threshold value of a bankrupt's home, up to which the home is exempt from creditor enforcement in bankruptcy. High homestead exemption in Florida and Texas recently came under intense scrutiny.

the government and the need to assure that essential services will continue to be provided to the people. In countries with administrative approaches, private creditors require approval by a higher tier of government to attach subnational assets.

When Hungary deliberated its subnational insolvency mechanism, it was recognized that the country's corporate bankruptcy law, in force since the late 1980s, was inapplicable to subnational borrowers. In the United States, a prominent judicial doctrine holds that only proprietary property is attachable. "Proprietary property", subject to debt foreclosure, was defined by the U.S. Supreme Court as "held in (the municipality's) own right for profit or as a source of revenue not charged with any public trust or use."⁵⁰ Property dedicated to "public use" such as streets, hospitals or courthouses is exempt even in the absence of specific statutory protection, as are funds held in the local treasury for general use. As a result, the backstop of private creditors' rights – the right to seize the property of the debtor – is often unavailable to subnational creditors.⁵¹

Another key difference between subnational and corporate bankruptcy lies in the procedure's partial insurance function. The debt discharge protects the subnational entity and its population from long-term harm caused by sharp decreases in public service delivery. Also, to allow a timely fresh start, one needs to balance incentives for the subnational entity to grow out of insolvency with repayment of creditors. As bankruptcy procedures lower the downside risk of borrowing, a higher bankruptcy exemption for essential public services could lower the supply of financing (White, 2005). There is thus a trade-off. Where to draw this line is a crucial question in the design of such legislation.

Insolvency in the private sector is defined as a situation where an entity's liabilities exceed its assets (overindebtedness) or the entity is unable to pay its debts as they fall due. Insolvency procedures often involve selling off assets to satisfy payment of liabilities. Those liabilities remaining unpaid are then de facto written off in liquidation. Reorganization procedures restructure liabilities in a legal procedure to allow a fresh start for viable entities.⁵² In reorganization, courts are usually empowered to "discharge" debt (debt adjustment).

In the design of subnational insolvency procedures, one needs to think outside the box of liquidation. Subnational governments cannot be liquidated like private corporations, unless another entity assumes their governmental responsibilities. Existing subnational insolvency mechanisms are all of the reorganization type. The entity continues to exist and the government remains in control, keeping some of its assets to ensure continued public goods provision. A quick economic recovery of the entity concerned is also in the best long-term interest of creditors as a group, since it heightens the probability of repayment.

⁵⁰ Variants of such limitations on attachment of subnational assets are found in many countries. An early example is a Swiss court judgment of December 15 1881. Speaking to Winterthur's financial distress, the court held that taxation power and those buildings serving a public purpose were outside bankruptcy. (Meili, 1885). Fasching (1983, 84) described the general principle of law that private rights against public bodies may be enforced as long as the existence and operation of the public entity is not endangered.

⁵¹ For a more detailed discussion, see McConnell and Picker (1993).

⁵² Chapter 11 of the US Bankruptcy Code.

In summary, the policy justification and legal procedures for private sector insolvency do not readily transfer to subnational entities. This results in a number of insolvency design features unique to subnationals. Defining “insolvent” through liabilities exceeding assets is of little use. Inability to pay debts as they fall due is more helpful. Yet because of required governmental tasks, the meaning of inability takes on a different meaning for public entities. Liquidation of all assets is infeasible, as at least some public assets are critical to carrying out important governmental tasks. These responsibilities are *independent* of the subnationals’ financial condition. The overarching aim of the procedure is thus financial rehabilitation of the debtor, and maximum recovery for creditors consistent with this objective.

3.2 Hard budget constraint for subnational entities

Unconditional bailouts of financially-troubled subnational entities by the national government create moral hazard and encourage fiscal irresponsibility and imprudent lending. A lax subnational budget constraint distorts the price signal guiding the allocation of credit, creates potential liabilities for the central government, and endangers macroeconomic stability. The time will come for over-indebted entities to confront a difficult economic and political reality. Their policy choices will be between raising taxes, cutting spending, lobbying the central government for a bailout or seeking relief from creditors.

In the United States, the no-bailout principle was established during the first subnational defaults in the 1840s. In 1842, eleven States and the Territory of Florida were in serious financial troubles. States and investors lobbied the federal government for bailouts. The no-bailout principle had the upper hand, and eight states and the Territory of Florida defaulted on their debt. The crisis prompted states to impose new limits on borrowing. Between 1842 and 1852, twelve States wrote new constitutions. Eleven adopted novel procedures for authorizing government borrowing.⁵³ The principle of no-bailouts has been upheld over various subnational default cycles.⁵⁴

As illustrated by the Hungarian case, the motivation for establishing a regulatory framework for subnational insolvency was to reduce moral hazard, impose a hard budget constraint for municipalities and shrink contingent liabilities of the central government.

⁵³ For a detailed account of state debt crises in the 1840s and resulting regulatory reforms, see Wallis (2004). Also see Scott (1974) for a history of state debt crises and repudiation in the United States. An interesting question is why such repudiation, the most extreme form of violating creditor rights, did not present a greater setback for the development of subnational capital markets. One should be cautious to extrapolate from the U.S. experience. In the typical middle-income country today, repudiation could have longer-term negative consequences for the development of capital markets.

⁵⁴ The subnational defaults during the Great Depression were exceptional insofar as widespread defaults were associated with an economy-wide downturn. Subsequently, subnational defaults in the United States have been much less infrequent. The hard budget constraint as practiced in the United States should not be misconceived as a complete hands-off approach by the states. As illustrated by the example of New York City, states in the U.S. do help restructure local government debt in exchange for fiscal reforms. Thus the hard budget constraint placed by states on local governments is more accurately described as conditional bailout.

After repeatedly bailing out subnational governments, Brazil followed a stricter approach, demanding subnational fiscal adjustment in return for fiscal relief.

However, abolishing central government guarantees for debt services of municipalities is not sufficient for nurturing the development of capital markets, as illustrated by the case of South Africa. The post-apartheid decentralized constitution ended the guarantee of local debt. But a range of factors affect demand and supply in the municipal finance market. A subnational insolvency mechanism is not a sufficient condition for growth in subnational debt market.

Insolvency mechanisms help enforce a hard budget constraint on subnational governments, but they are not sufficient. The design and implementation of intergovernmental systems exert profound influences on the fiscal behavior of subnational governments.⁵⁵ A gap-filling grant transfer system for example induces subnational governments to run fiscal deficit by reduced revenue efforts and increased incentives to spend. Lack of own-source revenues for subnational governments in many countries undermines the ability of subnational governments for fiscal correction, a core element of any insolvency mechanisms.⁵⁶ Furthermore, a competitive capital market prices risks and returns of subnational lending, helping screen and discipline subnational borrowing from the capital market side.⁵⁷

3.3 Clarity of rules

The twin aims of a subnational insolvency framework are to create a predictable and transparent framework for managing expectations about default and to coordinate competing interests on the subnational's financial recovery. The first enables accurate risk pricing and credit differentiation, and prevents moral hazard. The second helps the subnational to restore fiscal sustainability, which not only allows the subnational to carry out its governmental responsibilities while undergoing restructuring but also serves the collective interest of creditors.

Lack of clear rules for insolvency is likely to raise borrowing costs through higher interest rates, shorter maturity, or both, and thereby limits market access for creditworthy borrowers. The experience of Romania with municipal capital market shows this clearly: facing substantial uncertainty about available remedies upon default, private lenders are reluctant to supply credit to more municipalities, lower cost, or extend maturities. The South African case also demonstrates that a lack of clear rules for insolvency can impede the growth of a broad-based private capital market.

The insolvency framework aims to clarify rules on three key aspects of the insolvency process. The first aspect concerns orderly debt restructurings. The second aspect concerns

⁵⁵ For indepth discussions and a review of the latest literature on intergovernmental fiscal systems, see Ehtisham Ahmad and Giorgio Brozio (2006).

⁵⁶ See Ianchovichina, Liu, and Nagarajan (2006) for discussions on the influence of intergovernmental systems on subnational fiscal adjustment.

⁵⁷ Inman (2003) argues that a mature banking system and a competitive bond market are important factor in disciplining defaulting subnational governments and discouraging strategic borrowing.

maintenance of essential public services. The third aspect concerns structural adjustment to restore subnational fiscal sustainability.

In the absence of a clearly-defined framework for insolvency, subnational governments may adjust debts in negotiations with creditors or repudiate their obligations. As the experiences of the United States, Hungary, and South Africa show, ad-hoc debt restructurings are complex. Interests of the subnational government, which is responsible for maintaining essential minimum services, and those of creditors, who insist on fulfillment of contractual promises, diverge. Oftentimes, reconciliation through a voluntary bargaining process proves elusive.

Clear creditor remedies allow collective enforcement and facilitate efficient debt adjustment. Creditors' remedies in contract laws, instead of insolvency mechanisms, are effective to enforce discrete unpaid obligations. However, individual lawsuits or negotiations become ineffective if there is a general inability to pay. In subnational insolvency, individual negotiations with each creditor are impractical, costly and potentially harmful to the interests of the majority of creditors. A small group of creditors may derail a debt restructuring agreement reached between the debtor and creditor majority. This holdout problem causes uncertainty and prolongs the debt restructuring process. Resolving the holdout problem was the primary motivation for the United States to enact Chapter 9.⁵⁸

On maintaining essential public services, there are three general approaches. The first specifies a closed list of essential services (assets) in detail.⁵⁹ Second, a broad clause protects those assets used for public purposes (essential services). This distinction between property for public use and property for private use is a principle of subnational insolvency procedures. Such protection is at times found in a specific municipal insolvency statute; in the absence of a specific protective clause for subnational entities in the laws on attachment. Third, courts decide on a case by case basis, taking into account the fiscal and debt adjustment agreement reached between the debtor and creditors.⁶⁰

On fiscal adjustment, the insolvency mechanism, in combination with ex-ante regulation, can define various stages of financial distress and insolvency, using clearly-defined fiscal and financial indicators such as primary balance, debt service ratio, arrears, and liquidity. It can also spell out judicial or administrative proceedings for restoring fiscal and financial health to the troubled subnational entity.

Well-designed insolvency procedures have important ex-ante effects on incentives and anchor expectations of borrowers and creditors. For this reason, such a mechanism not only helps resolve financial distress ex post, but also deters irresponsible borrowing and imprudent lending ex ante. In the United States, Chapter 9 is designed to carry a strong stigma for the borrowing municipality, to offset debtor moral hazard. Municipalities are thus wary that capital markets would interpret the filing for federal bankruptcy protection

⁵⁸ See McConnell and Picker (1993).

⁵⁹ Hungary chose this approach. Cf. Annex to Law XXV (1996).

⁶⁰ The United States do not have a standard list for essential services. Courts therefore enjoy discretion to define the precise scope of essential services in their case law.

as a strong signal of financial mismanagement, to which lenders are likely to react by charging a risk premium.

In Hungary, four years after the enactment of the 1996 Act on Municipal Bankruptcy, only 11 out of 3158 municipalities filed for bankruptcy protection. There is strong evidence that the legislation preempted more filings, because creditors and debtors were encouraged to seek redress outside the court system and to take other steps to ensure solvency and operational efficiency. Furthermore, financial institutions have been more prudent in lending to municipalities.⁶¹ Although voluntary resolutions without insolvency procedures are unlikely, the mere existence of a legal framework which could impose solutions often induces voluntary agreements.

3.4 Equitable burden sharing

Clear rules ease the distributional struggle typical of insolvency. The basic tension between the need to maintain essential minimum services and the creditor's contractual rights implies that the pain of insolvency needs to be shared between lenders and debtors. The insolvency mechanism needs to balance these competing interests. This distribution matters also *ex ante*, as it shapes the expectation and behavior of borrower and lenders in the next cycle of borrowing.

In the aftermath of the Great Depression, Hillhouse described the situation in colorful words: "Every municipal default is like a drama in which there are many players. Bankers, lawyers, municipal bondholders, holders of the unfunded obligations and real estate mortgages, local officials, taxpayers, municipal employees and civic groups, all play some parts."⁶² To this long list, one should also add the central government. For example, in resolving the Brazilian subnational debt crises, almost the entire burden was placed on the central government.

What should a rational framework for subnational insolvency look like? This paper argued above that there are many benefits to clarifying the rules. One key component is establishing *ex ante* the repayment order in insolvency, which helps prevent moral hazard and encourage pricing of default risk by lenders.

The public nature of the debtor may justify curtailing creditors' valid private law claims. Creditors will insist that all valid debts be honored and repaid. *Ex ante*, the subnational entity will pledge assets for financial resources; *ex post*, it will argue that many assets cannot be used for the satisfaction of creditors as they serve a public purpose. The tension between creditor rights and subnational debtor's inability to pay is here to stay. This clash is at its extreme when a debt discharge is needed, a major curtailment of creditor rights.

⁶¹ See Jokay, Szepesi, and Szmetana (2004) for more discussion. In addition to the deterrence impact of the Act, the deficit grant program handled 700-1000 applications from 3,200 municipalities annually, which also served as a tool for bankruptcy prevention. Local governments must cut back discretionary activities and rationalize their expenditures to qualify for the grant program, *ibid*.

⁶² Hillhouse (1936), p. 428.

In principle the answer to this collision of interests is an equitable sharing of misery. Many corporate insolvency systems provide for equal creditor treatment of similarly situated creditors, including similarly situated foreign and domestic creditors. Without a strong reason to depart from this principle, like creditors should be satisfied equally. This principle would call, for example, for treating all bondholders equally. A subnational insolvency framework also provides guidance on the priority of settling competing creditor claims.

The economic literature on bankruptcy asserts that absolute priority rule (APR) is optimal, since it provides the right incentives for lending *ex ante* (White 2005). If lenders are repaid in the exact order of their lending, implying that no lender can jump the queue, then costs of additional lending are fully internalized and reflected in pricing. In other words, there is no risk of debt dilution, since the effect of the marginal dollar lent on the debtor's payment capacity is fully incorporated in the costs of lending.

Yet in practice, no country has adopted a pure absolute priority rule. The reason is twofold. Although the APR rule might be efficient *ex post*, it need not be efficient *ex ante*. The rule may have a deterrent effect on new lending, *even* when such lending is desirable. Debtor-in-possession financing in US corporate bankruptcy law addresses this concern. Contrary to the APR rule, priority is given to new financing once the debtor is under bankruptcy protection. The convincing rationale is to allow refinancing in financial distress.

Second, distributing the pool of available assets in bankruptcy is never about efficiency alone. The distributional impacts loom large. The APR is only one possible policy choice. Many other configurations of priority are possible. Which one is most appropriate for the insolvency of subnational entities will depend, first, on the distributional judgment of the society concerned and, second, on the effect of a chosen priority structure on the capital market and its impact of new financing during a liquidity crunch. It is also important to allow sufficient flexibility within a general priority framework.

In the absence of a binding priority structure, the defaulting borrower may choose the order in which to satisfy creditors. A subnational insolvency framework eliminates this source of arbitrariness by providing guidance on the priority of creditor claims. Yet the devil is in the details of "equitable priority structure". This notion will differ across countries, reflecting society's distributional judgments over sharing the insolvent's dwindling pie of assets.⁶³ The U.S. approach in Chapter 9 gives first priority to secured

⁶³ In German corporate bankruptcy, for example, wages, taxes and arrears to suppliers are in a first class, with shareholders in the second. In Japan, it is administrative claim holders, taxes, and workers' salary for three months prior to commencement of bankruptcy, other claim holders and finally shareholders. In China the order is secured debt, bankruptcy expenses, staff wages and insurance, followed by taxes, unsecured debt and shareholders. The priority structure of US corporate bankruptcy places secured creditors first and unsecured creditors second. In the second class, the debt adjustment plan determines the order of repayment. Restructuring practice tends to give high priority to bondholders in the second class. We are grateful to Darshini Manraj from Doing Business, World Bank Group for sharing the information.

creditors and second priority to unsecured creditors, after essential public services and costs of the bankruptcy proceedings are paid for. Hungary chose to give preference to subnational employees over creditors as a group.

A clear priority structure for settling competing claims expedites the resolution of debt restructuring. Priorities also ease the pain of sharing the reduced assets for distribution, because losses suffered by creditor groups may be predicted in advance. Hence, they are more likely to be accepted. Moreover, the structure can keep the absolute size of losses in check, since the costs of protracted negotiations and litigation are high and often take priority over other claims. Priorities are a policy choice with a variety of trade-offs. If the lending community perceives that financial distress is mostly resolved on its back, then desirable future lending could suffer. The shadow of priorities provides the backstop for voluntary restructuring negotiations, shaping bargaining power of creditors and debtor even outside bankruptcy.

One reason for introducing a subnational insolvency mechanism might be a desire to change leverage in the debtor-creditor relationship. Much will depend on shortcomings identified in the current subnational borrowing arrangements. If the analysis revealed that the current system is tilted in favor of borrowers, then the insolvency framework could be designed to shift bargaining power to the creditor. If on the other hand creditors enjoy too much leverage, then the insolvency system could provide more protection to a subnational entity in financial distress.

3.5 Judicial vs. administrative approach

This section contrasts two alternative approaches to subnational insolvency: the judicial and the political-administrative approach. In addition, various hybrids exist. Judicial procedures place courts in the driver's seat. Courts make key decisions to guide along the restructuring process. Administrative interventions, by contrast, usually allow a higher level of government to intervene in the entity concerned, temporarily taking direct political responsibility for many aspects of financial management.

The judicial approach tends to target insolvency and is triggered by the filing of a petition. Under the administrative approach, higher-level governments typically intervene earlier to prevent deterioration of subnational fiscal distress into insolvency. The judicial approach is rarely used in the United States, as Chapter 9 serves primarily as a deterrent.⁶⁴ The states in the United States have adopted various approaches to resolving local financial distress. New York and Ohio represent two broad intervention types: an early warning system to prevent local governments from slipping into fiscal distress (Ohio), and strong ex-post intervention by the state to restore local government solvency (New York).

⁶⁴ From January 1972 to June 1984, municipalities only filed 21 petitions under Chapter 9. Between 1938 and 1991, 452 municipal bankruptcy cases were filed. 343 of those were filed before 1952 (McConnell and Picker, 1993, at 471; Spiotto, 1984).

The choice of approach links in part back to the motivations. While Chapter 9 in the United States and Hungary’s legal insolvency mechanism deal with insolvency through the courts, South Africa’s legal framework is a hybrid, blending administrative intervention followed by judicial intervention if the financial distress deteriorates into insolvency. South Africa’s procedure in the event of municipal financial distress has three steps: an early warning system consisting of various indicators, intervention by provincial governments and then by the central government, and intervention by the judicial system in debt restructuring. Brazil has chosen an administrative approach to deal with subnational insolvency. In Hungary, for example, a desire to neutralize political pressure during the restructuring favored the judicial approach.

The earliest documented attempt of introducing a municipal insolvency procedure occurred in Switzerland. In 1883, four municipalities were on the brink of insolvency after a guarantee for the benefit of the Swiss National Railway Corporation was triggered. Insolvency was only averted by a sizeable federal bailout. This crisis prompted a search for a legal framework for municipal insolvency.

Friedrich Meili (1885), a renowned Swiss law professor, undertook a comprehensive survey on municipal insolvency for the Swiss federal government, and put forward a detailed proposal for a law.⁶⁵ *Meili* regarded the crisis of the four municipalities as a welcome opportunity to introduce clarity into the relationship between municipalities and their creditors. In his view, like to so many who followed, the main benefit is legal certainty.⁶⁶

The inherent political character of subnational entities is a key consideration in design. Subnational governments in many countries are elected. Their removal by administrative fiat or by a judge might directly conflict with the democratic governance at the subnational level. There is a need to safeguard internal decision making, which is peculiar to public bodies with elected officials, is referred to as “sovereignty concerns”.

A narrow scope of intervention is one way of safeguarding subnational autonomy. Under § 904 of the United States Bankruptcy Code, the federal court’s jurisdiction cannot exceed the debtor’s volition. Financial management remains the responsibility of the municipality. The court may not interfere with the municipality’s choice on services to citizens. It is the municipality’s prerogative to prioritize spending, within the envelope established through the adjustment plan. Hence, the insolvency mechanism is separate from internal decision-making. Court-ordered replacements of politicians are ruled out.

The United States displays an interesting variant of such “sovereignty concerns”. Chapter 9 vests jurisdiction in federal courts; this raises “sovereignty concerns”, since municipalities are creatures of the states. The solution adopted is the specific

⁶⁵ Entwurf zu einem Bundesgesetz betreffend die Schulbetreibung und den Konkurs gegen Gemeinden (Meili, 1885, at 249-258).

⁶⁶ Meili (1885).

authorization requirement of Chapter 9.⁶⁷ As a result, the federal bankruptcy courts cannot interfere with a state's ability to control its municipalities. This is a design issue unique to federal systems.

Outside insolvency, "sovereignty concerns" are apparent in the limitations on seizure of subnational property, which are found in many jurisdictions. Under this rule, a private person cannot attach public property for satisfaction of a debt. In extreme cases, attachment could endanger the municipality's functions. Importantly, if a court were to order such attachment, it would put the judicial branch in direct conflict with the subnational-administrative branch. As courts lack the political legitimacy for deep interference in financial affairs, "sovereignty concerns" are more pronounced under the judicial approach.

Nonetheless, the judicial approach does impose a disciplined structure for all parties to come to an agreement on fiscal adjustment and debt restructuring plans. It may not have the power to dictate the exact nature of fiscal adjustment, as municipalities are governed by elected officials. Interference in the subnational's sphere of responsibility is problematic,⁶⁸ because of the political nature of rights and obligations.⁶⁹ However, the mere existence of the judicial power in enforcing procedures for reaching agreement reduces protracted bargaining among various parties and gives clarity to the rules of negotiations.

One potential downside of judicial procedures is cost and duration. In the US, some Chapter 9 cases are complex and expensive. The most prominent example is Orange County's bankruptcy. For a small subnational entity the costs of such proceedings could be substantial compared to assets available for distribution to creditors. Furthermore, speed matters in debt renegotiations. Proceedings dragging on for years unnecessarily delay the entity's economic recovery. This concern is more pronounced in underdeveloped judicial systems. Yet collective enforcement via subnational insolvency mechanism, as opposed to individual creditor remedies, builds incentives for parties to reach agreement within a reasonable timeframe (Schwarz, 2002).

4. Subnational Insolvency Procedures: Key Elements

This section analyzes key elements of subnational insolvency framework based on the experiences of the United States, Hungary and South Africa. The focus is on central elements, to illustrate typical design choices a country faces when developing subnational insolvency mechanisms. The section does not discuss their full legal complexity. It

⁶⁷ Prior to the Bankruptcy Reform Act of 1994, only general authorization to file for bankruptcy was required. In the past, inference from general statutes was sufficient. After the 1994 amendment, a direct and specific enabling piece of legislation is required.

⁶⁸ Certain local government powers may be constitutionally protected and hence no interference is possible in insolvency. In the case of South Africa, strong intervention powers with decisions' of elected officials granted by Municipal Financial Emergency Act called for a constitutional amendment.

⁶⁹ See Hillhouse (1936) and De Angelis (2006). The political nature of subnationals adds complexity to defaults. According to Hillhouse (1936), the average local government default is highly complicated, since the subnational entity is a large aggregate of economic and social groups.

defines insolvency, which serves as trigger for the procedure, and discusses collective enforcement. The section then analyzes the dual adjustments during the insolvency proceeding. The first adjustment – fiscal adjustment by the debtor– is to bring spending in line with revenues and to bring borrowing in line with debt service capacity. The second adjustment is negotiations between creditors and the debtor to restructure debt obligations and potential debt relief.

4.1 Insolvency and commencement of bankruptcy

What is meant by “subnational financial distress” and “subnational insolvency”? While the economics literature approaches insolvency from the sustainability of fiscal policies,⁷⁰ specific legal definitions serve as “procedural triggers” for initiating insolvency proceedings. The typical administrative approach to subnational financial distress kicks in earlier than judicial procedures, before the subnational’s financial situation deteriorates into insolvency.

In a legal sense, subnational insolvency refers to the inability to pay debts as they fall due. Yet details vary across countries. In the United States, insolvency is defined as the debtor either: (i) currently not paying its debts as they become due, unless such debts are the subject of a bona fide dispute, or (ii) not being able to pay its debts as they become due.⁷¹ In Hungary, the two central triggers are: the debtor (i) has neither disputed nor paid an invoice sent by a creditor ... within 60 days of receipt or of date due if the due date is later; (ii) has not paid a recognized debt within 60 days of date due.⁷²

South Africa, by contrast, chose one set of triggers for “serious financial problems,”⁷³ and another for “persistent material breach of financial commitments.”⁷⁴ If the first set of triggers is met,⁷⁵ the provincial government may intervene. Under the second set of triggers, provincial intervention is mandatory. Unsuccessful provincial intervention calls for national government intervention. Interwoven with these interventions, the municipal government can apply to the High Court to stay all legal proceedings against the municipal government, and to relieve, suspend or discharge financial obligations.⁷⁶

In all three countries, statutory provisions empower the courts to dismiss petitions not filed in “good faith,” and prevent discharge of debt where the municipality can, in fact, pay the debt. This avoids problems that could otherwise arise where a subnational entity might file purely for the purpose of evading debt obligations.

⁷⁰ See for example Burnside (2005) on defining insolvency in general and Ianchovichina, Liu, and Nagarajan (2006) for its application to the subnational context.

⁷¹ Chapter 9 of the US Bankruptcy Code, 11 USC 101(32) (C).

⁷² Law on Municipal Debt Adjustment, Law XXV, 1996, § 4.

⁷³ South Africa, Municipal Finance and Management Act, 2003, Chapter 13, Section 138 (a) (b) (c) (d) (e) (f) (g) (h), including failure to make payments as and when due (a), defaulting due to financial reasons (b), current expenditure exceeding current revenues plus available surpluses for at least two consecutive years (c), and operating deficit to revenues greater than 5 percent (d).

⁷⁴ South Africa, Municipal Finance and Management Act, 2003, Chapter 13, Section 140, (1), (2), (3), (4).

⁷⁵ Any single indicator or a subset of indicators in the first set of trigger suffices.

⁷⁶ South Africa, Municipal Finance and Management Act, 2003, Chapter 13, Sections 152, 153, and 154.

In the United States, the cash-flow definition of insolvency for municipal differs from the balance sheet insolvency test used for corporations. For municipalities, the Bankruptcy Code looks to cash flow only, while for other debtors, it also looks to assets and liabilities. Even a municipality with many valuable assets can be insolvent. This reflects the common law view before the United States Bankruptcy Code, which treated the municipality as a debtor with few physical assets available for creditors and instead focused almost exclusively on the ability of the debtor to generate revenues through property taxation.⁷⁷

The insolvency definition in the United States serves as an effective gatekeeper, discouraging strategic municipal bankruptcy filings. The Bankruptcy Code erects obstacles to municipal filing beyond those faced by private debtors. Only municipalities face a statutory requirement of insolvency. Section 109(c) imposes a procedural bar that is unique to Chapter 9 debtors: It requires pre-filing efforts by the municipal debtor to work out its financial difficulties. The debtor must have reached agreement towards a plan, have failed to do so despite good faith negotiations or such negotiation must be “impracticable.” And, municipalities need state authorization to file for bankruptcy [(109 (c) (2)].⁷⁸

A subnational government can be financially distressed, yet solvent. Financial distress can be measured by various indicators, such as the ratio of current expenditure over revenues. The resulting operating deficit determines needed borrowing (a warning signal) and the ratio of debt service to total revenues, which measures the capacity to service debt. Each country’s definition is different. For example Brazil defines the debt service ratio as share of current revenue net of transfers (Brazil 2001), Colombia defines it as share of operational savings (Colombia 1997), Peru defines it as share of current income including transfers (Peru 2003), and Russia defines it as share of total budgetary expenditures (Russia 1998). Fiscal responsibility laws in various countries cap the ratio beyond which a subnational is deemed to experience debt distress.

Who can file for bankruptcy? The class of eligible filers differs across countries. In the United States, only the municipality can file for bankruptcy under Chapter 9, conditional on being insolvent, having worked or attempted to work out a plan to deal with its debts, and having been authorized by the state to file for bankruptcy.⁷⁹ The more stringent requirement for filing under Chapter 9, as comparing with filing under Chapter 11, is due to the constraint set by the U.S. Constitution. A creditor cannot bring a municipality, against its will, into a federal court, based on the 11th amendment of the U.S. Constitution. In South Africa, any creditor can file a claim against the municipality.⁸⁰ Similarly, in Hungary, a creditor can petition the court if a municipality is in arrears for more than 60 days.⁸¹ Schwarcz’s model law for subnational insolvency allows only municipalities to file.⁸²

⁷⁷ McConnell and Picker, 1993.

⁷⁸ Ibid.

⁷⁹ United States, Chapter 9, (109 (C) (2)).

⁸⁰ South Africa, Municipal Finance and Management Act, 2003, Chapter 13, Section 151 (a).

⁸¹ Law on Municipal Debt Adjustment, Law XXV, 1996. Four years after the Act, neither vendors nor banks petitioned for bankruptcy. According to Jokay, Szepesi, and Szmecana (2004), these creditors

4.2 Collective enforcement

An insolvency proceeding is the process by which a financially-distressed subnational entity resolves its debts collectively, as opposed to various individual and uncoordinated attempts at enforcement. Central to this process is a collective framework for simultaneously resolving debt claims when eligible assets fall short of liabilities or the debtor is unable to pay debts as they fall due.⁸³ Following the Great Depression, Hillhouse (1936) emphasized that the main aim of insolvency for public entities is to avoid unnecessary waste of time, money and energy by all parties that arise in countless unsuccessful attempts at individual enforcement.

The coordinating role of insolvency mechanisms is central. The implicit assumption is that the self-interest of creditors (as a group and taken individually) virtually always diverge, at least over the medium term. This could result in a breakdown in voluntary restructuring negotiations. In such circumstances there is a need for a procedure able to bind in holdout creditors, who refuse to go along with a restructuring.

The holdout problem arises from heterogeneity of stakeholders. For this reason voluntary negotiations may run out of steam and fail to provide a long-term solution. The underlying premise is that majority acceptance of an adjustment plan indicates that – in the majority’s judgment – the plan is in line with the entity’s capacity to pay. A holdout creditor may obstruct restructuring negotiations by refusing to accept the agreement, bringing suit on the original contract and trying to execute against attachable property of subnational entity.

The collection options against subnational governments tend to be limited, compared to corporations or individuals. The race to the courthouse is therefore a less salient concern. The need for a stay to conserve the current situation remains strong. A stay provides breathing space to the subnational entity to negotiate in good faith with its creditors, unobstructed by lawsuits. All current subnational insolvency procedures incorporate such a stay in one form or the other. A stay is an authorization by the bankruptcy authority freezing ongoing litigation and prohibiting further transactions. In the U.S. the stay is automatic; in South Africa court approval is required.⁸⁴

probably assumed that the local governments had few liquidable assets and that operational cutbacks could not produce a cash flow sufficient for fully satisfying claims.

⁸² Schwarcz (2002).

⁸³ Overindebtedness and inability to pay are the two primary triggers for insolvency, variants of which are found in many corporate and personal insolvency statutes.

⁸⁴ The stay on litigation is the most highly developed mechanism to prevent a rush to the courthouse. It is postponement of ongoing and future collection efforts against the debtor. A more primitive instrument is the moratorium. The debtor unilaterally ceases to pay mature debt, while acknowledging the validity of the debt obligations. As a unilateral arbitrary act, the moratorium is at odds with a developed legal system. A standstill refers to a unilateral engagement by its creditors not to press their claims while the debt is restructuring, without intention to be legally bound, *given* that the subnational entity has suspended debt service payments.

An effective, transparent and predictable system should provide strong incentives for collective action, encouraging creditors and lenders to conduct restructuring negotiations early.⁸⁵ This phenomenon is a variant of “peace through deterrence.” Negotiated adjustments involving all stakeholders are the most cost-effective and efficient tool to resolve financial distress. If the shadow of insolvency is too remote and interests diverge, such voluntary bargaining will fail. This provides the rationale for off-the-shelf insolvency legislation for subnational entities. In systemic crises, there may be a need for interim framework enhancement measures tailored to the circumstances of the crisis at hand, without undermining the basic arrangements of the established insolvency framework.

4.3 Fiscal adjustment

Fiscal adjustment and consolidation are preconditions for financial workouts and recovery. Often fiscal mismanagement is the root cause of subnational insolvency. If the municipality and other stakeholders fail to address the underlying causes, and yet all debts were discharged through some insolvency mechanism, then the subnational government could jump onto another cycle of fiscal mismanagement and financial distress. Even if when subnational insolvency is triggered by exogenous shocks such as a sharp rise in real interest rates through currency crisis, fiscal adjustment is inherent to the insolvency proceeding.

Financial distress is often the result of fiscal mismanagement. For example, New York City fiscal crisis in 1975 resulted from persistent operating deficits and an oversized public sector (Bailey, 1984). In South Africa, fiscal mismanagement and failure to raise revenue were among the major causes of subnational financial stress after the ending of apartheid regime (Glasser, 2005). Borrowing for commercial activities and for operational deficits and unchecked fiscal management prompted financial distress of many Hungarian local governments in the first part of the 1990s (Jokay, Szepesi, and Szmetana, 2004). Fiscal deterioration of Indian States in the late 1990s was attributed to rapid increases in salaries, pensions, and subsidies; and rising debt services as the result of rising borrowing cost and increases in borrowing to support growing operating deficits. Contingent liabilities associated with fiscal support to the public sector units, cooperatives, and the statutory boards heightened fiscal risks (Ianchovichina, Liu and Nagarajan, 2006).

Besides fiscal mismanagement, macroeconomic shocks also affect subnational insolvency. Macroeconomic crises – currency depreciation, inflation and rising interest rates – exacerbated the vulnerability of subnational fiscal positions and led to subnational debt crises in countries such as Mexico (1994-1995), Russia (1998-1999), and Argentina (2000-2001). However, macroeconomic crises were not the sole cause of the subnational debt crises in these countries; it only exposed and exacerbated the vulnerabilities already rooted in subnational finances. Deficiencies in the intergovernmental fiscal system,

⁸⁵ Examples of such incentive devices are stays on enforcement and the cram down power (see footnote 83).

expected guarantees by central governments for subnational debt, and non-transparent fiscal accounting all contributed to the subnational debt crises.

Ianchovichina, Liu and Nagarajan (2006) present a framework for analyzing subnational fiscal adjustment. Subnational debt sustainability is influenced by economic growth of the subnational economy, real interest rates, and the subnational's primary balance. They argue that subnational fiscal adjustment qualitatively differs from national fiscal adjustment. The former is complicated by the respective legislative mandates of central vis-à-vis subnational governments and the intergovernmental finance system. Unable to issue their own currency, subnationals cannot use seigniorage finance. Subnationals cannot freely adjust their primary balance due to legal constraints on raising own revenue, dependence on central government transfers, and central government influences key expenditure items such as wages and pensions. If public sector banks dominate lending, lending rates could be subsidized, bank lending to subnational entities could exceed the statutory requirements, and credit risk concerns could be compromised. Many policies that affect economic growth and fiscal health of the subnational economy are designed largely or exclusively by the central government.

Even in a decentralized system such as in the United States where subnationals have broad freedom to control expenditures, raise revenues, affect the interest rate spread in a competitive capital market, and influence growth environment, fiscal adjustment often requires difficult political choices of cutting expenditure and raising revenues.

In administrative approaches to insolvency, the scope of intervention by higher levels of government in subnational fiscal adjustment is often extensive. Judicial interventions vary across countries, depending on the relationships among the judicial, executive and legislative branches. Since courts are to interpret law but not to legislate, and the courts in many countries are independent of the executive branch, courts' interventions into subnational fiscal adjustment are narrower than under the administrative approach.

In the United States, Chapter 9 explicitly protects the right of the state to control its political subdivisions and the right of the municipal debtor to manage its internal affairs. Section 904 provides that the court may not interfere with the "political or government powers of the debtor" the "properties or revenues of a debtor" or the "debtor's use of or enjoyment of any income-producing property." The effect is to preserve the power of political authorities to set their own spending priorities, without constraints imposed by the bankruptcy court. As part of fiscal adjustment the court can issue mandamus. This is not direct judicial interference in the political subdivision of the state, but enforcement of the power granted by the state to municipalities to levy taxes for debt payment.⁸⁶

In contrast to the narrow judicial role in fiscal adjustment of municipalities, state laws in the United States for distressed municipalities commonly provide for a transfer of control over municipal affairs. This confirms that in the United States noninterference is an artifact of federalism rather than an expression of inherent autonomy of municipalities.⁸⁷

⁸⁶ McConnell and Picker, 1993.

⁸⁷ Ibid. Note that in other countries, noninterference could be the direct result of constitutional protection for municipalities' autonomy.

The cases of New York City's fiscal crisis and the Ohio Fiscal Watch Program illustrate the State's direction of municipal fiscal adjustment. Courts' interventions, by contrast, tend to be less intrusive.

In Ohio, the Fiscal Watch Program is implemented by the Office of Auditor of State. The program has a detailed list of indicators (such as wage arrears, deficits, payment arrears, cash shortages, etc) to monitor the fiscal health of local governments. The Fiscal Emergency Law has three intervention modalities: fiscal caution, fiscal watch, and fiscal emergency.⁸⁸ If a local government's fiscal deficit exceeds one-twelfth of its annual revenue, the state auditor issues a fiscal watch warning. Local authorities then need to limit spending and build reserves. For example, the Auditor of State provides outlines options for budget cuts and operational improvements.

Once a local government is declared in fiscal emergency, the state establishes a financial planning and supervisory commission. The municipality needs to submit a detailed fiscal adjustment plan to restore financial health. The commission has the power to review taxation, spending, and borrowing policies to ensure consistency with the fiscal adjustment plan, to bring civil actions to enforce the Fiscal Watch Program and to ensure proper accounting and reporting.

Higher levels of government prescribe transparency in reporting and auditing. This is an unsurprising common feature of subnational fiscal adjustment across countries. As a key aim of fiscal adjustment, transparency helps a subnational government re-access capital markets. It facilitates private creditors to accurately price credit risk. As part of the administrative intervention for the city of New York, the Office of Special Deputy Comptroller for New York City was created to improve the accounts jointly with the Financial Control Board. In Ohio, the purpose of the Financial Planning and Supervisory Commission is to ensure that accounts, accounting systems, and financial procedures comply with the rules established by the auditor of the state. By the same token, fiscal transparency in accounting and reporting is a key element of recent fiscal responsibility legislation in Brazil, Colombia, and Peru.⁸⁹

4.4 Debt restructuring and discharge

Debt restructuring lies at the heart of any insolvency framework – judicial or administrative. Without an insolvency framework, subnationals and their creditors can only resort to consensual and ad hoc restructuring negotiations. Success in such restructurings is often elusive, especially when debtor-creditor and within-creditor interests diverge. Collective action is thus a central challenge. Coordination is harder the larger and the more anonymous the group of lenders. Compared to bank lending, subnational bondholders are more anonymous and more widely dispersed. When a

⁸⁸ Ohio Code on Local Fiscal Emergencies (Title 1, Chapter 111): Financial emergency: (i) more than a 30-day default on a debt obligation, (ii) a failure to pay employees within 30 days, or (iii) a deficit or overdue amounts payable exceeding one-sixth of the previous year's revenue.

⁸⁹ Brazil (2000), Colombia (2000), and Peru (2003).

voluntary arrangement cannot be reached, the cram down power⁹⁰ given to an independent party becomes critical.⁹¹

In administrative interventions, the higher level of government often restructures the subnational's debt obligations into longer-term debt instruments. In the case of New York City, the Municipal Assistance Corporation was set up to issue longer-term bonds of the state to repay maturing short-term obligations of the city.⁹² In Brazil, the federal government routinely restructured subnational debt. However, fiscal austerity or subnational fiscal adjustment needs to accompany debt restructuring, to minimize the moral hazard of debt restructuring. This was precisely what happened to New York City in 1975 and to Brazil in the 1997 debt restructuring agreement between the federal government and states.

While administrative approaches tend to focus on debt restructuring, independent courts are viewed as best equipped to discharge debt. Debt discharge is a major departure from the principle that contracts ought to be fulfilled.⁹³ Overriding contracts requires strong justification. A mature judicial mechanism is well placed to ensure that discharges are fair and equitable. As a result, discharges are typically limited to judicial mechanisms. In South Africa, for example, the municipality needs to go to the court for a discharge. Administrative procedures, on the other hand, tend to lack the power to discharge debt.

Ex-post modification of contracts needs to be tightly circumscribed. If creditors feel treated unfairly, there is a substantial risk that they will stop lending. Perceptions of "equitable" are likely to differ across countries, as distributional judgments are involved. While the procedure could narrowly focus on debtor moral hazard, purely exogenous factors could have caused the subnational's inability to pay. Absent imprudent lending, this potentially still leaves an irreconcilable gap between binding contractual commitments and payment capacity. This is where the debt discharge comes in.

Debt restructuring and debt discharge are complex processes. This paper is interested in two basic questions: whether creditors and debtor can reach agreement on debt resolution; and who holds the cram down power when both sides fail to reach an agreement. Above all, reorganization law structures negotiations to encourage a solution acceptable to all. Substantive requirements as to the contents of the plan are typically few.

⁹⁰ Court confirmation of bankruptcy plans despite opposition of certain creditors. Under 11 USCA § 1129b, Courts may thus confirm a plan if it (a) was accepted by at least one impaired class, (2) does not discriminate unfairly, and (3) is fair and equitable.

⁹¹ Under the US Bankruptcy Code, the court has the power to "cram down" an agreement on a dissenting minority. The plan may still be confirmed if creditors in each class receive value under the plan equal to the amount of their claims, or if creditors whose claims are junior in priority receive nothing (§ 1129).

⁹² To make the MAC bonds more attractive, the state legislature declared the stock transfer tax and the city sales tax to be state tax, and directed revenues from these be transferred to a fund under the MAC management and applied to the debt service and administration cost (Bailey, 1984).

⁹³ In the United States, the Contracts Clause of the US Constitution ([Article I. 10.1](#)) puts the principle of contract a sunt servanda into constitutional form.

In US municipal bankruptcy law, the municipal debtor controls the debt adjustment plan and modifies the terms of existing debt instruments. The critical question is what the debtor is able to do over the objection of creditors. The standards for confirming a Chapter 9 plan are complex. Nonetheless, Chapter 9 incorporates basic Chapter 11 requirements: at least one impaired class of claims approves the plan; secured creditors to receive at least the value of the securitized property; unsecured creditors often lose out.⁹⁴

In private insolvency, objecting unsecured creditors are entitled to be paid in full as long as stockholders receive any value on account of their stock. Subnationals have no stockholders. Their officials need not to pay off unsecured creditors to remain in control. Therefore unsecured creditors would look for protection to 943 (b) (7) of Chapter 9, which requires the court to decide that the plan is in the “best interests of creditors and is feasible.” The court would ensure that bondholders effectively receive what they would have received outside of bankruptcy.⁹⁵

In Hungary, the Debt Committee is chaired by a court-appointed financial trustee, who is required by the debt law to be independent of the local government under proceeding. The Committee is charged with preparing a reorganization plan and debt settlement proposal.⁹⁶ Fiscal and debt restructuring proposals are decided by majority vote of the Committee and presented to creditors. A debt settlement is reached if at least half of creditors whose claims account for at least two-thirds of total undisputed claims agree to the proposal. Creditors within the same group must be treated equally.⁹⁷ The Act also stipulates the priority of asset distributions. If disagreements arise on distribution, the court makes the final decision which cannot be appealed.⁹⁸

South Africa’s legislation stipulates that debt discharge and settlement of claims must be approved by the court. The settlement of claims follows the following order specified by the Municipal Finance Management Act: (i) secured creditors, provided that the security was given in good faith and at least six months before mandatory intervention by provinces; (ii) preferences provided by the 1936 Insolvency Act; and (iii) non-preferential claims be settled in proportion to the amount of different claims.⁹⁹

The rescaling of debt obligations is a major intervention in contract rights. Insolvency law reconciles this clash of creditor rights and inability to pay. It formalizes the relationship between creditors and subnational debtor in financial distress. Insolvency law closes the legal order by curing previous contractual violations through a new legal

⁹⁴ For more detailed case histories, see Kupetz (1995) and McConnell and Picker (1993).

⁹⁵ Ibid.

⁹⁶ Law on Municipal Debt Adjustment, Law XXV, 1996, Chapter II, § 9 (3) stipulates that the financial trustee’s independence.

⁹⁷ Law on Municipal Debt Adjustment, Law XXV, 1996, Chapter III, § 23.

⁹⁸ Law on Municipal Debt Adjustment, Law XXV, 1996, Chapter IV, § 31. Assets are distributed to creditors in the following order: (1) regular personnel benefits including severance pay; (2) securitized debt; (3) dues to the central government; (4) social insurance debts, taxes, public contributions and tax; (5) other claims; and (6) interest and fees on debt obligations continued during the bankruptcy proceeding.

⁹⁹ South Africa, Municipal Finance and Management Act, 2003, Chapter 13, Section 155 (4).

act.¹⁰⁰ A procedure for subnational insolvency recognizes that resolving financial distress via mechanisms guided by law is to be preferred over muddling through repeated, costly and often unsuccessful negotiations.

5. Lessons and Conclusions

This final section draws out lessons for middle-income countries in Asia, Latin America and Eastern Europe. It highlights policy considerations and trade-offs in designing subnational insolvency procedures.

A commonly held belief asserts that default happens only where subnational entities and the central government are financially weak. The evidence belies this statement. Subnational financial distress is an increasingly common phenomenon in many middle-income countries. Subnational insolvency mechanisms ought to be on the reform agenda in a wide range of developed and developing countries.

Ex-ante borrowing regulation and ex-post insolvency mechanisms complement each other.¹⁰¹ Insolvency mechanisms increase the pain of circumventing ex ante regulation for lenders and the subnational borrower and thereby enhance the effectiveness of preventive rules. Without an ex-post insolvency mechanism, ex-ante regulation can easily turn into excessive administrative control and bargaining between the central and subnational governments.

A good subnational insolvency mechanism encourages voluntary bargaining in the shadow of bankruptcy law, anchors risks and rewards of borrowing ex ante, is tailored to the specific country circumstances, and is perceived as balanced (“equitable”) by all stakeholders.

The mere existence of subnational insolvency mechanisms helps shape incentives ex ante.¹⁰² Aligning incentives of all players and establishing a predictable set of rules for allocating default risk are at the heart of insolvency mechanisms. These incentives encourage lenders and debtors to comply with rules voluntarily, because if they do not, they suffer the consequences. While the full financial implications of default cannot be spelled out ex ante, subnational insolvency procedures go a long way in anchoring restructuring and negotiations. Lenders are aware of the circumstances under which they

¹⁰⁰ The US experience suggests that public entities in financial distress will resort to use every possible technicality to challenge the validity of their outstanding obligations in the absence of a bankruptcy framework (Hillhouse, 1936, at 157ff). Widespread challenges in a default wave of the 19th century lead to the development of the bond council opinion, which certifies that the obligation is legal, valid and enforceable.

¹⁰¹ See Ter-Minassian and Craig (1997) for a summary of ex-ante subnational borrowing control frameworks in over 50 countries, and how these control frameworks reflect “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” (p.169).

¹⁰² Even if used only rarely, subnational insolvency mechanisms shape bargaining power in voluntary restructuring negotiations. In the US, for example, the mere presence of Chapter 9 (the shadow of bankruptcy law) prods parties to voluntary agreement.

may have to take losses. This enhanced predictability on returns to capital is likely to lower the cost of lending to creditworthy subnationals.

Insolvency procedures strengthen the hard budget constraint. Subnationals then stand on their own feet as borrowers. When restructurings become institutionalized, pressure for political ad-hoc intervention decreases. Enhanced credibility for the non-bailout promise better aligns incentives. They know that over-borrowing, particularly for operating deficits, will imply painful adjustment. Subnational insolvency procedures also serve several macroeconomic goals. First, effective insolvency and creditor rights systems allow better management of financial risk. Minimizing systemic risk in the banking sector enhances financial stability. Second, they ensure efficient access to credit and allocation of resources (World Bank, 2005).

Competing considerations need to be balanced in designing subnational insolvency procedures. First, protecting creditors' rights is critical to the development of embryonic capital markets. Second, continued provision of public goods requires that some assets of the subnational entity be exempt from bankruptcy. Third, it is important to resolve the tension with subnational autonomy, and potentially the government's electoral mandate. Fourth, the design needs to be consistent with the broader cultural, economic, legal and social context of the country. Many desirable design features, as apparent from different motivations of present subnational insolvency legislation, are country-specific.

Policy objectives of debt restructuring and the subnationals' circumstances influence design. For example, countries differ considerably in how they balance forgiveness against creditor recovery and the stigma attached to default. Furthermore, the constitutional setup affects but does not determine the choice of an administrative, judicial or hybrid approach.¹⁰³ In the United States, for example, municipalities possess no constitutional personality. Thus, theoretically, they can be created and destroyed by their state.¹⁰⁴ In South Africa, before the constitutional amendments, few remedies existed to effect debt and fiscal adjustments for a financially-troubled local government. South Africa amended its constitution to expand the power of other spheres of government to intervene in legislative aspects, such as the budget or the imposition of taxes.¹⁰⁵

Subnational insolvency procedures become more important as the subnational bond markets deepen. The competition between subnational bank lending and bond financing tends to lower lending costs and extend maturities. However, a large number of bondholders exacerbate the collective action problem. Insolvency procedures reduce protracted and costly negotiations between the debtor and numerous creditors. If a

¹⁰³ In countries where reforms are proceeding on multiple fronts, the constitution itself can be subject to change, as illustrated by the constitutional amendments in South Africa to pave the way for establishing an insolvency framework.

¹⁰⁴ *Hunter v. City of Pittsburgh*, 207 U.S. 161, 178 (1907) (holding that localities are no more than "convenient agencies for exercising such governmental powers of the State as may be entrusted to them").

¹⁰⁵ There are considerable debates within South Africa on whether the interventions are too strong.

country relies largely on relationship-based banking, the need for an insolvency framework is less pressing.

The lack of a subnational insolvency procedure is a smaller concern where higher levels of government exercise tight control over subnational borrowing.¹⁰⁶ However, as countries decentralize expenditure, taxation and borrowing, subnational insolvency procedures become more relevant. Subnational borrowing can expand fiscal space for infrastructure investments, promote fiscal transparency, and deepen financial market reforms.

Complementary systemic reforms are important. Insolvency procedures are only part of the broader institutional reforms; they are important elements but not sufficient to generate a competitive municipal finance market. First, subnational insolvency mechanisms cannot compensate major deficiencies in intergovernmental fiscal relations. Examples are unclear expenditure assignments and absence of clear own-source revenues for subnational governments. Improved decentralization frameworks and expanded subnational fiscal autonomy underpin subnational fiscal strength. Such strength is fundamental for access to capital markets.

Second, incentive signals of insolvency mechanisms require a competitive subnational capital market. In countries where a few lenders, particularly the public lending institutions, dominate subnational credits, the lack of incentives for monopolistic creditors to price returns and risks undermines the effectiveness of insolvency mechanisms. Subnational insolvency mechanisms are also embedded in contract and securities law and anti-fraud enforcement, which help lower cost, increase investors' confidence, and deepen financial markets.

Capacity and entry point matter. The maturity of the legal system influences the choices of procedure. Implementation of insolvency procedures – in the corporate and the subnational context – rests on the shoulders of insolvency experts and on institutions (courts) resisting political influence and corruption. In many emerging economies, limited judicial and administrative capacity may be a binding constraint. The first focus should be on developing institutional ingredients and on training bankruptcy professionals. In countries where the judicial system is embryonic, formal procedural guidelines might be a stepping stone to a fully-developed mechanism. This interim solution can be used to build up institutional and professional capacity and restructuring expertise (Gitlin and Watkins, 1999).

Lack of comprehensive and timely information is another major constraint. Fiscal transparency and adequate reporting systems, in the lead-up to financial distress, are preconditions for successful insolvency mechanisms. Corporate bankruptcy law relies on full disclosure of assets and liabilities. Similarly, subnational insolvency procedure would require public disclosure of comprehensive financial information, including hidden and contingent liabilities.

¹⁰⁶ Many continental European countries have elaborate administrative mechanisms for supervising the actions of subnational governments, including their financial management.

This paper explained why subnational insolvency procedures matter. Much ground remains to be covered. The scope could be broadened to include other countries, such as Canada, Italy, Japan and France. Future research might evaluate the procedures' effectiveness, their impact on subnational borrowers' incentives to default, their effect on the size of subnational capital markets, and the strength and weaknesses of the various procedures. To policymakers, how to transplant and adapt such mechanisms to country-specific circumstances will be of particular interest. Economists could refine the meaning of insolvency for public entities. Lawyers could flesh out how courts deal with subnational insolvency. It is hoped that this article sparks interest in the subject.

Annex 1: Main Elements of Subnational Insolvency Procedures

	Hungary	South Africa	United States ¹⁰⁷
Insolvency Triggers	1. Invoice not disputed or paid within 60 days. 2. Not paid a recognized debt within 60 days (§4 Law XXV (1996)).	1. Serious financial problems or anticipation of such problems. 2. Persistent material breach of financial obligations (Chapter 13, Sections 136, 137, 138, 139).	1. Debtor generally not paying due debts. 2. Unable to pay debts as they become due.
Covered Entities	Local governments (Ötz).	Only municipalities, not provinces.	Municipalities (all political subdivision and public agencies of a state) (§921).
Eligible filings	Municipality or creditor through court petition.	Provincial/national executive decides based on insolvency triggers. Municipality admits to existence of trigger with application for a stay. Any creditor can file a claim.	Only the municipality itself (no involuntary filings) (§921).
Role of courts	Reviews petition, appoints financial trustee, approves reorganization/liquidation plan; broad role for financial trustee.	Limited, elaboration and approval of plan in administrative branch; court approves stay and debt restructuring.	Takes key procedural decisions, approves restructuring plan.
Stay	No enforcement outside the Act after commencement (Section 11).	Municipality may apply if unable to meet commitments, not automatic. (Section 152).	Automatic with bankruptcy petition (§362; §922).
Obtaining Credit	Possible if necessary to conclude a compromise (Section 34).	No specific provision in statute.	Possible, if municipality could borrow money outside Chapter 9 (§364).
Recovery Plan Approval	Creditors holding 2/3 of amount and 1/2 of eligible claims.	Plan elaborated by Municipal Financial Recovery Service and approved by Provincial Executive, not creditors.	Creditors holding 2/3 of amount, 1/2 of eligible claims (§§1124, 1126, Chapter 11 requirements).
Essential services	Annex A: Mandatory Municipal Tasks (27 items).	Suspension of financial obligations only after provision for basic municipal services; term not defined in the legislation. (Section 154).	Not defined, courts tend to construe narrowly.
Conditionality ¹⁰⁸	Substantial, in the hands of the receiver. Approval by representative body generally required.	Very strong, including dismissal of non-essential employees and liquidation of assets, as specified in recovery plan.	Limited, depends on bargaining outcome between creditors and municipality.
Priority of claims	1. Wages; 2. secured claims; 3. CG crisis support; 4. social security claims; 5. Other claims (section 31).	1. Secured creditors. 2. Unsecured creditors pro rata (Section 155).	1. Administrative claims. 2. Secured creditors. 3. Unsecured creditors.
Subnational autonomy	Crisis budget plan elaborated under supervision of financial trustee, who determines necessary assets.	Strong powers of intervention, constitution amended to allow such strong intervention.	No interference with any political or policy choices (§904). Requirement of state consent (§903).
Dismissal	1. Filer not eligible. 2. Council did not authorize (Section 8).	Not applicable, because within the purview of administration.	“Bad faith” of debtor (§930): 1. Unreasonable delay prejudicial to creditors. 2. Failure to propose plan. 3. Plan not accepted/denied. 4. Material default on terms of plan.
Experience	19 procedures, 100 out-of-court settlements.	None (Chapter 13 entered into force in July 2006).	> 50 filings since 1945, substantial number of

¹⁰⁷ This table covers only Chapter 9, not fiscal and debt adjustments for local governments by states outside Chapter 9.

¹⁰⁸ Adjustment measures which may be prescribed in exchange for a restructuring/debt relief.

			settlements and state procedures.
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