Turkey: Strengthening the Framework for Sub-national Borrowing

Selected Issues

A Policy Note

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Sustainable Development Department
Europe and Central Asia Region
The World Bank

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EXECUTIVE SUMMARY

1. **Local government finance has taken on increasing importance in Turkey, with the evolving fiscal decentralization and the growing role of local administrations in public investment.** The focus of this policy note is on sub-national borrowing as an essential component of the framework for sustainable sub-national finance. Sound management of sub-national borrowing is important for ensuring debt sustainability. Past problems with fiscal deficits by local administrations in Turkey have led to two major debt restructurings. The Government has undertaken many laudable improvements in the system of fiscal management and control of local administrations in recent years, in particular by regulating the procedures for borrowing, raising the requirements for accounting and reporting, and tightening the terms for Treasury guarantees of foreign borrowing.

2. **As local borrowing will continue to gain importance in Turkey to finance the growing investment requirements, the experience of other countries in refining their systems for sub-national debt management may be of interest to the Government.** The present policy note discusses both the *ex ante* rules for sub-national borrowing in place in Turkey in light of comparative international experience, as well as the *ex post* responses in cases where local authorities do not meet their payment obligations.

3. **Concerning the *ex ante* rules, three areas are noted where the Government may find international experience of interest:** (i) narrowing the scope for discretion in application of the borrowing limits; (ii) specifying borrowing rules for municipal enterprises; and iii) prohibiting borrowing to cover operating deficits. On the last point, some countries have found it helpful to introduce the "golden rule", requiring a balanced budget net of public investment. Although there are analytical and implementation challenges with such rules, they help establish an environment of discipline and some assurance to creditors by avoiding persistent non-balanced budgets.

[1] The policy note is produced for the Municipal Finance AAA (P110545). The discussion of Turkey draws from the World Bank Mission Aide Memoire (May 2008), and reflects comments on the aide memoire received from Treasury, Ministry of Finance, and Iller Bank. The discussion of international experiences draws largely from Liu and Waibel (2008a, 2008b). The policy note has benefitted from comments from Christine Kessides and Mark Thomas, peer reviewers William Dillinger and Matthew Glasser, and other participants at a Bank review meeting in March 2009, and from an informal working level review by staff from Treasury. The findings and conclusions expressed herein are those of the author and do not necessarily reflect the views of the World Bank and, its affiliated organizations, or those of the Executive Directors of the World Bank or the governments they represent.

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4. **Turkey may also find useful international experience of developing a formal or explicit *ex post* arrangement to address possible cases when municipalities do not meet their financial payment obligations, which may arise due to either macroeconomic shocks or weak financial management by local administrations.** International experience demonstrates four *de facto* options in such cases: default, unconditional bailout, judicial restructuring of individual cases based on contract law, and an insolvency framework. Insolvency mechanisms can further be administrative, courts-led, or a hybrid approach. The main advantages of a well-designed insolvency framework are that it can provide clarity and certainty to the parties involved—creditors, debtors, and the Government in its oversight capacity—and act as a commitment device to promote responsible behavior and enforce the hard budget constraint. As in the country cases discussed (the United States, Brazil, Hungary, and South Africa), an insolvency framework is developed in the context of the respective intergovernmental finance and borrowing system, as well as the country's institutional capacity in terms of legal, administrative and judicial arrangements.

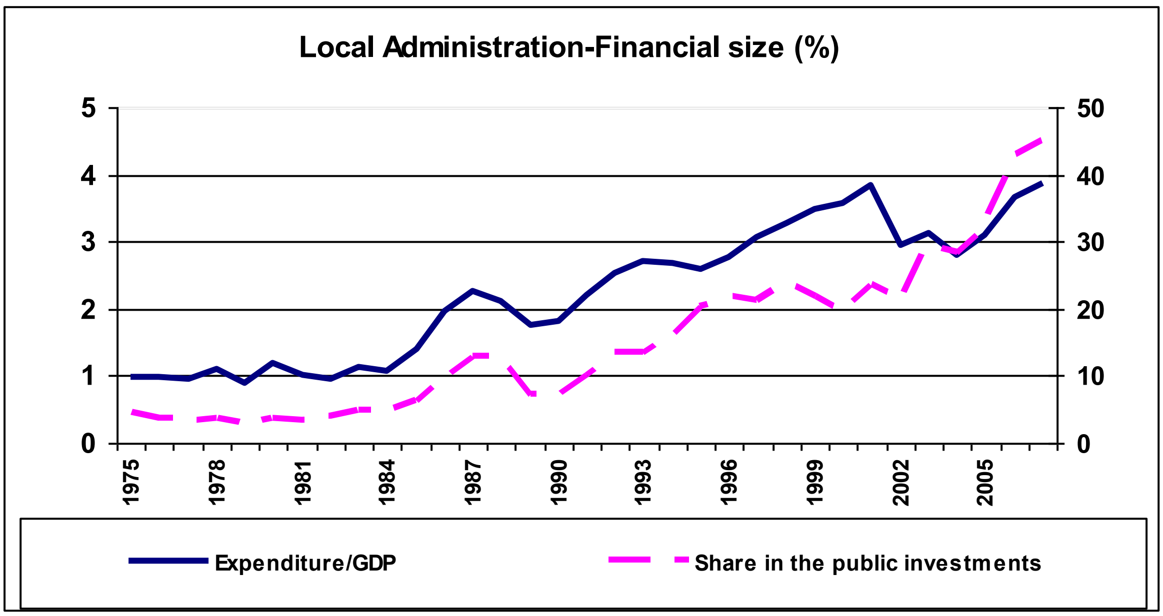
5. **Regardless of the particular entry point, or whether more reliance is placed on judicial or administrative approaches, an effective insolvency framework has as its core the necessary fiscal adjustment and debt restructuring.** The essential public services provided by sub-national government are protected during the financial insolvency, which also balances the interests of the creditors. It is necessary to reconcile the conflicting interests of the borrower and the creditors, and both sides need to share the pain of insolvency. The insolvency procedures of the U.S., Hungary and South Africa are illustrated in terms of three key design elements in all such frameworks: defining the triggers for insolvency, ensuring fiscal adjustment, and specifying a priority structure for debt restructuring.

6. **While developing a formal insolvency mechanism could be helpful for Turkey, it would not be sufficient for enforcing a hard budget constraint.** Equally important are the incentives that local administrations face to continue their own revenue efforts and to exercise self-discipline in fiscal affairs. In this context the recent measures to require local administrations to adopt more complete and reliable financial reporting are very significant. Transparency of the financial accounts of local administrations is a basic precondition for responsible financial management. These improvements will also help to promote the evolution of a more diversified and competitive municipal credit market. This outcome would be further enhanced with the eventual reform of Iller Bank to make it true development bank. The increased use of private credit ratings of sub-nationals can also be a helpful practice to encourage a more mature municipal credit system. Credit ratings will be especially relevant for the municipalities with a strong revenue base, and they will be the most likely to become eligible to access credit from multiple sources.

I. INTRODUCTION

1. **Local government finance has taken on increasing importance in Turkey**. This development is reflected in the rising share of local administrations (municipalities, metropolitan municipalities, and special provincial administrations) in the public investments and in expenditure over GDP on the expenditure side (Figure 1). On financing sources, various sources as share of GDP have also risen: general budget tax share increased from 0.73 in the period 1975-80 to 1.24 in the period 2002-07, own revenues share increased from 0.33 to 1.99 and borrowing from 0.04 to 0.49 over the same period.[3] The rising share of sub-national finance in consolidated public finance is observed across countries, though the size of sub-national finance in total public finance varies considerably across countries, dependent on the extent of fiscal decentralization.

Figure 1. Increased Importance of Local Administrations' Finance in Turkey



Source: "Financial Structure of Local Administrations in Turkey" State Planning Organization, May 22, 2008.

2. **The importance of local government finance is expected to continue in Turkey due to large investment needs of municipalities.** Rapid urbanization requires large investments in quality provisions of water supply and sanitation, solid waste disposal and wastewater treatment, and public transportation. Large-scale investments are needed to meet the environmental norms and standards of the European Union (EU), of which

[3] State Planning Organization (2008). "Financial Structure of Local Administrations in Turkey". Powerpoint presentation, May 22, Ankara. The national budget tax revenues assigned to local administrations are projected to increase further as a result of a new revenue sharing law enacted in July 2008.

Turkey is an accession candidate.[4] Due to co-financing requirements, sub-national borrowing is expected to play an important role in financing infrastructure.

3. **Sound management of sub-national borrowing is important for ensuring debt sustainability**. Local governments in Turkey experienced financial difficulties with rising fiscal deficits in the 1990s, leading to two debt restructurings in 2002 and 2005 to help reverse the fiscal decline. Turkey is a member of the Council of Europe, which in 1996 recommended precautionary rules (No. R 96-3) for managing sub-national debt.[5] Furthermore, the Maastricht Agreement requires EU members to keep total public debt, including regional and local government debt, below 60% of GDP, and annual budget deficits may not exceed 3% of GDP.[6]

4. **Turkey has moved steadily toward establishing a policy and regulatory framework, of international standards, for sub-national borrowing.** As in other middle income countries such as Brazil, Colombia, India, Mexico, Peru, Poland, Russia, and South Africa, the development of such frameworks is mainly motivated by two forces.

5. **First, in most regions of the world sub-national borrowing has grown, owing to widespread decentralization of spending responsibilities, taxation power, and borrowing capacity to sub-national governments, and to mobility of capital and diversification of financial instruments.**[7] Sub-national governments account for a significant share of consolidated public finance in countries such as Brazil, China, India and Russia. In Turkey, 45% of public investments were undertaken by local governments in 2007.[8] In addition, sub-national borrowers also include public utility companies and other special-purpose government entities.

6. **The benefits from sub-nationals' access to financial markets are numerous.** Borrowing enables local government to capture the benefits of major capital investments immediately, rather than having to wait until sufficient savings from current income can be accumulated to finance them. Financing infrastructure through debt instruments enables the matching of the maturity of debt with the economic life of the assets that the debt is financing. Moreover, allowing creditworthy sub-national governments to access capital markets exposes sub-national governments to reporting requirements, thereby potentially strengthening fiscal transparency. Furthermore, expanding sub-national borrowing facilitates financial market reform. Bond financing can become a viable alternative to bank lending at least for large borrowings, thereby deepening the structure of financial markets.

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[4] State Planning Organization (2008). "Financial Structure of Local Administrations in Turkey". Powerpoint presentation, May 22, Ankara.

[5] Jokay Charles, "Municipal Borrowing – Best and Worst Practices from a Regulatory Perspective", Dec 21, 2006, unpublished manuscript.

[6] http://eur-lex.europa.eu/en/treaties/dat/12004V/htm/C2004310EN.01033701.htm

[7] The term *sub-national* refers to all tiers of government and public entities below the federal or central government. Sub-national entities include states or provinces, counties, cities, towns, public utility companies, school districts, and other special-purpose government entities that have the capacity to incur debt.

[8] State Planning Organization (2008). "Financial Structure of Local Administrations in Turkey". Powerpoint presentation, May 22, Ankara.

7. **Second, the risk of sub-national insolvency has become evident.** To many observers, runaway provincial debt in Mendoza and Buenos Aires was a major factor behind Argentina's sovereign debt default in 2001. Brazil experienced sub-national debt crises in 1993 and 1997 following the earlier one in the 1980s. The 1995 Tequila crisis in Mexico exposed the vulnerability of sub-national debt to the peso devaluation and many Mexican sub-nationals entered debt crisis. In Russia, at least 57 of 89 regional governments defaulted from 1998 to 2001. As noted above, local governments in Turkey have undergone two major debt restructurings within the past seven years.

8. **Fiscal stress and implicit liabilities from borrowing are a real threat.** There is increasing recognition of off balance-sheet liabilities as a source of fiscal risks at all levels of government. Like the national government, sub-national governments are often called upon to provide guarantee to public sector entities and enterprises under their charge. These liabilities are difficult to estimate and yet could deal a severe blow to the sub-national's fiscal and financial health when they are "recognized". With the renewed interest in public private partnership in infrastructure (much of which would be undertaken by sub-national governments), fiscal risks also come from explicit, implicit, or contingent liabilities arising from contracts and guarantees to insure the private sector against risks.

9. **The ongoing global financial crisis threatens sub-national (and national) fiscal sustainability in many countries.** Slower economic growth and revenue shortfalls are likely to reduce sub-nationals' own revenues and fiscal transfers from the national government to sub-national governments, while fiscal transfers account for a majority share of sub-national revenues for many sub-national governments in developing countries (e.g., Colombia, Mexico, Russia, Poland). States and municipalities in the United States are struggling financially. Furthermore, deteriorating macroeconomic fundamentals are likely to impact the fiscal accounts and debt profile of sub-national governments in countries such as Argentina, Hungary and Ukraine.

10. **Many countries realize that the solution to the risks of sub-national borrowing should not lie in prohibiting it, as there are numerous benefits from granting sub-nationals access to financial markets.** As a way forward, these countries seek to develop a regulatory framework that can help expand sub-national borrowing, strengthen sub-national fiscal discipline, and manage potential risks, while at the same time supporting reforms in the intergovernmental fiscal system and deepening financial market reforms for more efficient utilization of capital.

11. **This paper focuses on frameworks for sub-national borrowing, an element of sub-national finance.** While recognizing that other components are as important to the sustainability of sub-national finance, such as spending and revenue assignments, intergovernmental fiscal transfers, financial management and controls, and the competitive structure of the sub-national credit supply market, these topics are addressed in other ongoing World Bank work with the government, and will be discussed only briefly with relevance to sub-national borrowing.

12. **The rest of the policy note is organized as follows**. The next section summarizes the framework for sub-national borrowing in Turkey and reviews areas for further

development – including in particular, an effective insolvency mechanism. Section III presents rationales for a sub-national insolvency mechanism and describes how the entry points for reform have contributed to varying modalities across countries. Section IV discusses key design issues for a sub-national insolvency mechanism, driven by the fundamental difference between public and private insolvency. Final section V presents possible medium-term reform options for Turkey.

II. THE FRAMEWORK FOR SUB-NATIONAL BORROWING IN TURKEY

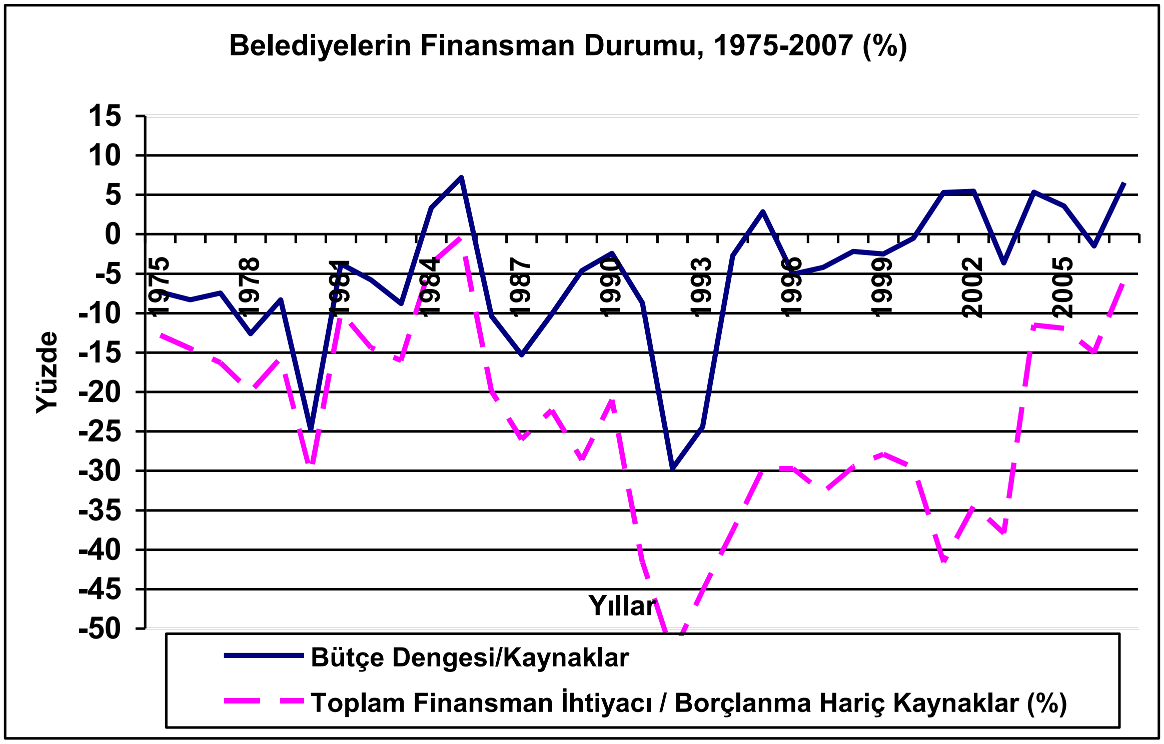
Sub-national debt overhang

13. **Largely unregulated borrowing by local authorities in the 1990s, supported by extensive Treasury guarantees for foreign debt, led to the accumulation of a substantial sub-national debt overhang in Turkey.** Figure 2 presents the increasing financing gap for municipalities. Although the budget deficits of municipalities decreased, financing needs did not decrease due to the debt service.

14. **In 1999, about 90 percent of the Treasury guaranteed debt service of local administrations was called.** In 2002 there was a restructuring of the foreign debt, and in 2005/06 a restructuring for intergovernmental arrears. A large portion of guarantees have been converted to debt now held by the Treasury.

15. **Turkey has implemented significant reforms to develop a regulatory framework for sub-national borrowing**. These measures are a recognition that sub-national debt financing is likely to continue to be an important feature of the capital finance framework, driven by large local infrastructure financing needs arising from rapid urbanization, the need to meet environmental norms and standards of EU, and the need to co-finance EU grants.

Figure 2. Budget Deficits and Financing Gaps of Municipalities in Turkey



Note: Upper line is the fiscal deficit; lower line is the total financing requirement/revenues.
Source: "Financial Structure of Local Administrations in Turkey" State Planning Organization, May 22, 2008

16. It is also useful to place the reforms undertaken within the broader context of EU requirements. Box 2 presents EU requirements for public indebtedness including local government debt.

Box 2: EU Legal Requirements on Public Indebtedness

The Maastricht Agreement requires EU members to keep overall public debt below 60% of GDP, and annual budget deficits may not exceed 3% in any given year. The Maastricht Treaty states that the debt of municipalities and all other sub-sovereign units of government (excluding commercial operations) are also counted against these limits. The Council of Europe, of which Turkey is a member, recommended in 1996 (No. R 96-3) to establish "precautionary rules" that prevent excessive borrowing, while supporting the principle of subsidiarity, sustainable development and local autonomy. The Council recommended: (i) establishing a critical threshold of indebtedness; (ii) developing indicators, supported by regular reporting, that include the ratio of debt payments to revenues, maximum collateral, the ratio of debt to assets and limiting the types of security that may be offered; (iii) defining how the 60% Maastricht limit will be divided among national and local levels; (iv) clearly stating the consequences of local insolvency; and (v) explaining guarantees to agencies outside the budget and loans and repayment schedules, in separate reports attached to budget documents. Source: Jokay (2006)

Significant reform steps taken

17. **The measures taken by Government in recent years to regulate borrowing by local administrations incorporate many principles of international good practice aimed at mobilizing resources within an environment of fiscal discipline.** Not only has progress been considerable, but the government has signaled its intention to continue to develop the legal and regulatory framework and capacity for monitoring the financial health of local administrations. Notable steps in recent years include the following.

- The Municipality Law (No: 5393 of 2005) has set borrowing limits regulating both the total debt stock including interest (up to 150 percent of the previous year's revenues adjusted for inflation for metropolitan municipalities and their affiliated institutions and municipal companies, and to 100 percent of such revenues for other municipalities, their affiliates and companies). In addition, the annual flow of domestic borrowing in relation to same revenues (above 10 percent) has to be authorized by the Ministry of Interior Affairs.

- Law 5393 requires quarterly reporting to the central government. These are significant steps in signaling to local administrations that more fiscal discipline is necessary.

- The Treasury guaranteed share of the total foreign debt held by local administrations declined from 32.9 percent in 1999 to 15.7 percent in the third quarter of 2008.

- The Treasury introduced charges for the guarantees provided for foreign borrowing. Foreign currency borrowing by local administrations may incur a charge of up to 1 percent for a government guarantee.

- Law 4749 (2003) enabled past due Treasury receivables to be collected in accordance with the strict provisions of Law on the Procedures for the Collection of Public Claims.

- The rate paid by local administrations for arrears on loans provided by the Treasury (including called guarantees converted to loans) has been fixed at the Treasury cost of borrowing as opposed to a negotiated rate. The Treasury is considering further adaptation of this rate. Moreover, Treasury which is responsible for approving the non guaranteed external debt of municipalities will not give approval for external borrowing by any municipality with outstanding arrears to Treasury once the related communiqué is enacted.

- The Public Finance Department of the Treasury has established a system for assessing and rating the credit risk of local administrations, from A to F by taking into account the relationship of the municipality with the Treasury and their financial accounts.

- The Treasury has the authority to obtain data on indebtedness of local administrations from domestic financial intermediaries according to Law 5787 (July 2008).

- The Public Financial Management and Control Law No. 5018 (amended 2005), which covers local administrations, envisages a financial management and control system based on management accountability and a functionally independent internal control system. The Ministry of Finance (MOF) is responsible for setting standards and the Internal Control Coordination Board is in charge of internal control. Regulation functions have mostly been completed and efforts are focusing on capacity building. Ministry of Finance is publishing quarterly local administration revenue and expenditure figures.

Areas where further reform could be considered

18. **To continue the move toward international good practice, the government may wish to address missing elements or possible issues in the current legal and regulatory system.** These are summarized below as *ex ante* and *ex post* aspects of the borrowing framework, as well as in the area of reporting of sub-national fiscal accounts to facilitate market access and macroeconomic monitoring. As Turkey is relatively more advanced in the *ex ante* rules, the rest of this section II focuses on the remaining areas for possible strengthening in this area, while Sections III and IV focus on the scope for a *ex post* rules (a sub-national insolvency system), referring to international experience and key design issues to be considered.

Remaining Questions Regarding the Ex Ante Rules for Municipal Borrowing

19. The recently elaborated *ex ante* rules as outlined above leave several aspects unaddressed or raise particular issues, as listed below:

- *Discretionary Application of Borrowing Limits.* The borrowing limits prescribed by the legislation discussed above are subject to exceptions provided on a discretionary basis. For example, the prescribed borrowing limit of 10 percent of revenues can be exceeded with the approval of the municipal council and the Ministry of Interior (MOI) (Article 68f, Law 5393). The borrowing limit regulating total debt stock in relation to revenue capacity may be breached to finance "advanced technology" and large infrastructure projects, provided the SPO and the Council of Ministers approve (Article 68f, Law 5393). This part of the legislation was canceled for one year with the 2009 budget law. Therefore, the exceptions to the municipal borrowing limit are eliminated temporarily for the 2009 budget year.

In general, discretions could undermine the credibility of the rules-based system that recent legal and regulatory changes are seeking to establish. Sending the signal that sustainable indebtedness levels are not a binding constraint could encourage local administrations to seek their own exceptions to the rules, while those who abide by them are penalized. Experience in countries like Brazil in the late 1990s, with significant regional political economy tensions, has shown that a dynamic of high level exceptions can easily lead to rapid expansions in sub-national debt. Moreover, the budgetary costs of such exceptions are masked by allowing borrowing that could lead to rescheduling later. Finally, the use of discretionary exceptions to debt limitations prolongs the financial dependence of local administrations on the national government and encourages potential private investors to expect central guarantees to manage their risks.

- *Non-Application of Borrowing Limits to Municipal Companies.* It appears that the current legal and regulatory framework may be offering municipalities a "soft option" to shift borrowing to their affiliated utility enterprises and companies. Local administrations are allowed to establish companies, under Article 52 of Special Provincial Administrations Law (No.5302) and Article 70 of Municipality Law (No. 5393), which operate as private legal entities. Although the capital of local administration companies consists almost entirely of public funds, the legal arrangements for the public audit of these companies are not rigorous and do not take adequate account of the financial risks that these companies pose for the finances of the local administrations that own them.

- *Potential Borrowing for Operating Deficits.* There is no explicit provision in the Municipality Law to prohibit borrowing to finance operating deficits. The regulation of foreign debt specifies that it is only acceptable to finance investment, but this does not appear to preclude operating deficits being financed through domestic borrowing. To restrict all borrowing to finance only investments has become an element of the borrowing framework across an increasing number of countries (discussed further in section V).

- *Local Administrations Borrowing in Foreign Exchange.* Borrowing by sub-nationals in foreign exchange is risky, and many countries simply prohibit it without central government guarantees. The Turkish government carefully controls the volume of foreign borrowing by local administrations by approving all such transactions. Because of the nature of the borrowing in foreign exchange, which is often from IFIs and increasingly from commercial banks, the government also guarantees most of these loans. Local administrations have little or no capacity to hedge foreign exchange risk. Any official default on foreign borrowing is, however, costly and a threat to sovereign rating. With a guarantee, the Treasury bears the cost of providing a de facto foreign exchange hedge to the beneficiary local administrations. Although as previously mentioned the Treasury charges up to 1% of the guaranteed amount, it may wish to consider an explicit charge for foreign exchange hedging.

Supplementing the Ex Ante Rules with an Ex Post Framework for Addressing Financial Distress

20. **The legacy of accumulated arrears and liabilities of local administrations from the 1990s led to two rounds of debt restructuring to convert their debts to obligations of long-term maturity to the central government, e.g., extending to 50 years.**[9] This process has reduced the indebtedness and thus created "fiscal space" for local administrations and protected the delivery of local services. Nonetheless, the debt restructuring has apparently imposed little cost to sub-national governments, which may lead to the expectation by the sub-national governments and the credit market for implicit government backing of future borrowing.

21. **The legal framework does not currently provide a clear mechanism for resolution of municipal insolvencies.** IFC's internal assessment, in 2008, of the municipal

[9] The 2005/06 debt restructuring covered YTL 19.1 billion total outstanding municipal liabilities to the public entities as of end-2004, though only YTL 14.3 billion were restructured.

insolvency mechanisms in Turkey indicated that municipalities have a separate legal personality from the central government and may be sued. However the legal framework does not currently provide a clear mechanism for resolution of municipal insolvencies, and there are no precedents that provide guidance. A municipality's immovable properties and assets which are allocated to public services may not be attached. The term 'public services' is not defined in local law and may be interpreted broadly; hence in practice it may be difficult to collect receivables from municipalities.

22. **The debt restructuring process can be strengthened by creating *ex post* rules for borrowing, i.e., an explicit or formal insolvency mechanism as discussed in Sections III and IV.** Such rules can also be applied to implicit debt through running arrears. International experience shows that an insolvency framework can make the *ex ante* rules more effective by imposing fiscal discipline as preconditions for debt restructurings. The *ex post* rules would spell out the consequences of sub-national insolvency or other fiscal stress, and distribute the costs of fiscal and debt adjustment appropriately between creditors and the borrower. Establishing predictable rules helps reduce contingent liabilities of the central government, and provides comfort and valuable information for potential private investors on the profile of local administrations' credit risk and what creditors can expect in the event of defaults.

Sub-national Credit Market

23. **The sub-national credit market in Turkey is still quite underdeveloped, however.** This situation can be attributed to the relatively recent experience with fiscal decentralization, and past macroeconomic difficulties that curbed the appetite for long-term domestic lending. In 2007 local authorities accounted for only 2 percent of total long-term public debt, compared to more than 10 percent for the EU 25. Most long-term financing has come from foreign sources, especially IFIs. Only a few metropolitan municipalities are creditworthy for international commercial lenders. Private bank participation in municipal financing remains scarce. The most important single lender to the municipal sector has been Iller Bank, a state institution (see Box 1). In this context of a relatively immature market the Government's approach to sub-national borrowing would reasonably aim both to encourage the responsible growth of borrowing by creditworthy municipalities, and to create an environment that discourages abuse or mismanagement of the borrowing authority.

Box 1: The Special Role of Iller Bank in Municipal Credit Supply

Iller Bank is the primary development and investment bank for local authorities, and is especially important for the small and medium sized municipalities. Iller Bank is legally constituted as a municipal credit cooperative, but is essentially a central government-owned and -directed institution. Iller Bank's two main functions—transferring central tax revenues to the local authorities on a monthly basis, and supporting municipal infrastructure investment through technical assistance, loans and grants—make it a key partner for most municipalities, and a major source of municipal loans in the country. A draft law proposes to turn Iller Bank into a true investment and development bank to provide banking functions and be fully subject to the Banking Regulatory and Supervisory Board regulations. Under the proposed law Iller Bank would be capitalized by Treasury and report to it, instead of to a line ministry. As part of its ongoing institutional development, Iller Bank has already established a Risk Monitoring Unit and Internal Audit Unit to move towards practice as a financial intermediary for foreign loans. Iller Bank is also appraising projects with far more financial, technical and economic criteria than in the past. These are all developments in the direction of becoming a regular municipal banking institution.

Providing Reliable Sub-National Fiscal Accounts

24. **As local governments finance has gained importance, timely disclosure of reliable financial accounts of local governments and municipal companies would be a key requirement for macroeconomic management.** This is clearly recognized by all parts of the government responsible for municipal finance (e.g., Treasury, MOF, and MOI). The current vulnerability in the system of local government accounts is quite typical of a country undergoing decentralization of many key expenditures and revenues.

25. **Under the legislative framework in Turkey, the following government ministries/agencies collect sub-national finance data**: State Planning Organization (SPO), MOI (which has an important audit function for local administrations), MOF, Treasury, Court of Accounts, and possibly others**.** Law 5393 requires that local administrations submit their quarterly report of assets and liabilities to MOI, MOF, SPO and Treasury. The implementation of this provision has recently begun. In mid-2007 the MOF started to consolidate sub-national and national public finance data. Considerable efforts have been made in collecting data and training staff.

26. **The consolidation is challenged by the uneven financial reporting by local administrations**, owing to capacity constraints of many local administrations, as well as the continuing consolidation of smaller municipalities into larger ones (per Law No. 5747).[10] Moreover, different methodologies used for assessing key sub-national financial measures and diverse reporting software have exacerbated the problems. Reconciliation of alternative approaches leads to considerable delays in release of the data to concerned parties, thus further compromising the quality of the information on which critical policy decisions would need to be made. Of particular concern is the accuracy of information regarding intergovernmental accounts payable and receivable (including municipal enterprises and companies).

[10] In 2008 the number of Local Administrations in Turkey was reduced from 3200 to 2100, which may ease some of the difficulties of financial reporting.

27. **Even in large metropolitan municipalities, such as Bursa for example, there are several fiscal data sources for the municipality but it is difficult to reconcile them.** Variables and entries are not standardized across files and years. Thus it is difficult to build a consistent fiscal account (covering key variables such as different types of expenditures and revenues, borrowing from all sources, debt stock and debt services, primary balance and consolidated fiscal deficit) across years for any meaningful medium-term fiscal framework analysis, and fiscal and debt monitoring.

28. **Each of the different agencies that have significant fiduciary responsibilities over local administrations has been receiving only a part of the information critical to fulfilling their respective roles.** However, in recent months the concerned agencies have started meeting regularly to share information on the asset and liability accounts of local administrations.

29. **Regarding all the above areas of financial policy, it is useful to consider the heterogeneity of municipalities.** There is significant diversity of characteristics and needs of municipalities in Turkey (or any other country), measured by a municipality's own-revenue strength, economic growth and diversification, size of population, urban or rural setting, human capital and infrastructure development, resource base, and public administrative capacity. All these factors contribute to the credit rating of a municipality (Liu and Tan, 2009). For those municipalities (especially small ones) with a weak revenue base who are unlikely to become creditworthy, intergovernmental grant transfers are likely to remain the dominant source of financing, and fiscal reporting and monitoring can be streamlined. As a rule, larger municipalities with a strong revenue base would have greater capacity to qualify for access to commercial credit and capital markets and are expected to meet higher standards for financial reporting. But for all municipalities, it is useful to apply equally basic principles underlying good fiscal management, including transparency of their financial accounts, hard budgets, and an absence of bailouts from the central government.

III. RATIONALE FOR ESTABLISHING A SUB-NATIONAL INSOLVENCY MECHANISM[11]

30. **Sub-national insolvency mechanisms address the inability of sub-national entities to meet their payment obligations.** The mechanisms pertain not only to explicit debt liabilities from borrowing by sub-national entities, but also the consequences of fiscal budget mismanagement that leads to arrears even in the absence of borrowing from financial markets.

31. **There are basically four ways of dealing with insolvency:**

(i) Defaults (e.g., U.S. states in 1840s; many Russian regional governments defaulted from 1998-2001);

[11] This section draws from Liu and Waibel (2008a, 2008b).

(ii) Unconditional bailouts (e.g., in Brazil, two state-level debt bailouts in the 1980s and mid-1990s);

(iii) Courts-led restructuring of individual cases, through contract law enforcement (e.g., local debt crises in the U.S. Great Depression in the 1930s, which did not work well due to a lack of structure for settling disputes among debt holders);

(iv) An insolvency framework, which has three different types:

- Administrative (e.g., New York State's administered debt restructuring of New York City in 1975; Brazil's 1997 institutionalized debt restructuring);

- Court-led (e.g., federal municipal bankruptcy law in US and Hungary);

- Hybrid (e.g., South Africa).

32. The focus of this policy note is on the fourth option—formal or explicit insolvency frameworks—as established by several countries, so as to share experience. Sections below summarize the rationales for an explicit or formal mechanism, which have motivated these countries, and explain that entry points for reforms and country context matter a great deal in considering if and when to adopt an insolvency system.

Enforcing hard budget constraint

33. **In general, sub-national insolvency mechanisms, together with *ex ante* regulations, function as a commitment device to require sub-national governments to access the financial market within a common framework.** An individual sub-national government may adopt unsustainable fiscal policies for a variety of reasons. Inherent incentives exist for a sub-national government to free-ride—it bears only part of the cost of unsustainable fiscal policies, but it alone receives all benefits. Realizing these benefits depends on good fiscal behavior by most of the other sub-national governments. So collectively, governments benefit from a system of rules (commitment device) to discourage such defection and free-riding. The commitment device controls and coordinates sub-national governments across space in various localities and across time to commit future governments to a common borrowing framework (Webb 2004).

34. **A well-designed insolvency mechanism helps enforce the commitment device and hard budget constraint on sub-national governments.** Unconditional bailouts of sub-national entities by the national government would create moral hazard and encourage fiscal irresponsibility and imprudent lending. A lax sub-national 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 reality. The policy choices will then be raising taxes, cutting spending, accumulating arrears, lobbying the central government for a bailout, or seeking relief from creditors.

35. **In the United States, the no-bailout principle was established during the first sub-national 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.[12] The principle of no-bailouts has been upheld over various sub-national default cycles.[13]

36. **In Hungary, the motivation for establishing a regulatory framework for sub-national insolvency was to reduce moral hazard, impose a hard budget constraint for municipalities and limit contingent liabilities of the central government.** After repeatedly bailing out sub-national governments, Brazil followed a stricter approach, requiring sub-national fiscal adjustment in return for debt restructuring.

37. **Insolvency mechanisms help enforce a hard budget constraint on sub-national governments, but they are not sufficient.** For example, the intergovernmental finance systems exert profound influences on sub-national fiscal behavior.[14] A gap-filling grant transfer system, for example, induces sub-national governments to reduce revenue efforts and increase spending. Furthermore, Inman (2003) argues that a mature banking system and a competitive bond market are important factors in disciplining defaulting sub-national governments and discouraging 'strategic" borrowing.

Maintaining public service and protecting creditor rights

38. **Equally important, insolvency procedures can help an insolvent sub-national government maintain essential services while restructuring its debts.** Because sub-national governments perform public functions, they cannot be liquidated and dissolved like private corporations. Reorganization is the essence of insolvency for public entities. Ultimately, sub-national governments need to be financially healthy, and even after a default can reach a point where they might reenter the financial markets.

39. **But it is important that the insolvency proceeding be fair to creditors—to protect creditor rights, which are crucial to developing diversified and competitive sub-national credit markets.** A 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. Romania's experience with the 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 its

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[12] See Wallis (2004) for details. 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 sub-national 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.

[13] The sub-national defaults during the Great Depression were exceptional insofar as widespread defaults were associated with an economy-wide downturn. Subsequently, sub-national defaults in the United States have been much less frequent. As illustrated by the example of New York City (Bailey 1984), states do help restructure local government debt in exchange for fiscal reforms. The current financial crisis has increased pressure for federal assistance to subnational governments.

[14] For indepth discussions and a review of the latest literature on intergovernmental fiscal systems, see Ehtisham Ahmad and Giorgio Brozio (2006) and Anwar Shah (2008).

cost, or extend maturities. The South African experience in the late 1990s also demonstrates that a lack of clear rules for insolvency can impede the growth of a broad-based private capital market. It was the lack of clarity about what would happen in the event of a default, rather than actual insolvencies, that was a barrier to lending.

Providing a collective framework

40. **To balance the interests of creditors and the debtors, insolvency mechanisms establish a set of predetermined rules to allocate default risk.** These rules anchor the expectations of both borrowers and lenders that both sides share the pain of insolvency. Pressures for political ad hoc intervention decrease as restructurings become more institutionalized. Enhanced credibility for the no-bailout promise better aligns incentives. Effective insolvency and creditor rights systems allow better management of financial risks.[15]

41. **The need for a collective framework for resolving debt claims is even greater in the context of numerous creditors.** Individual creditors often demand preferential treatment and threaten to derail debt restructurings voluntarily negotiated between a majority of creditors and the sub-national debtor (the so-called holdout problem).[16] Creditors' remedies under contract law (instead of insolvency mechanisms) are effective to enforce discrete unpaid obligations, but they fail if there is a general inability to pay. In systemic crisis, individual ad hoc negotiations can be costly, impracticable, and harmful to the interests of a majority of creditors. The holdout problem is not as serious if debts are concentrated in a few banks. However, a collective framework for insolvency restructuring takes on more importance as sub-national credit markets develop—with thousands of creditors.

Country models and entry points for reform

42. **There are various country models of insolvency frameworks.** In the United States, the Bankruptcy Code (1937) Chapter 9 applies to municipalities in some states (the filing of Orange County bankruptcy in 1994 being the largest case),[17] and states intervene in municipal fiscal and debt adjustment (e.g., New York State enforced New York City's politically difficult fiscal adjustment in return for debt restructuring). Hungary's Law on Municipal Debt Adjustment (Law XXV, 1996) is another model, as is South Africa's Municipal Financial Management Act (2003) Chapter 13, and Brazil's federal government and states debt restructuring program (1997).

[15] The World Bank (2005) addresses creditor rights and insolvency standards in the context of corporate bankruptcy. Key principles apply to the sub-national context, bearing in mind the differences between public and private bankruptcy.

[16] The inability to compel holdouts to cooperate in a negotiated compromise motivated the passage of Chapter 9 of the U.S. Bankruptcy Code (McConnell and Picker 1993).

[17] Chapter 11, the U.S. bankruptcy law for corporations, has significantly affected other countries. Similarly, Chapter 9 of the Bankruptcy Code has influenced sub-national insolvency frameworks in countries such as Hungary and South Africa.

43. **The motivations for developing insolvency frameworks differ across countries, reflecting their political, economic, and legal and historical contexts.** These differences affect the entry point for reform and the framework's design.

44. **For example, although the U.S. municipal bankruptcy framework offers a valuable reference for other countries, the framework itself cannot be copied without care.** Chapter 9 of the U.S. Bankruptcy Code 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 or where lending to sub-national governments is dominated by a few public institutions, it is important that the development of a sub-national insolvency mechanism be sequenced with other reforms.

45. **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 insolvent municipalities.** Because 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.

46. **South Africa's motivation for enacting a municipal insolvency framework differed from that of the United States.** After the fall of apartheid, the government viewed insolvency procedures as an essential part of a new unifying framework to govern municipal finance. Deteriorating financial positions of several amalgamated municipalities increased the uncertainty perceived by private lenders.[18] 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, which gives public lenders a competitive advantage over the private sector.[19] From 1997 to 2000, private lending remained stagnant, and the expansion in municipal debt was driven by public sector lending particularly by the Development Bank of South Africa. Thus, in the view of the government, clarity about the rights and remedies of private lenders was important to broaden and diversify the municipal finance market.[20]

47. **South Africa went through a lengthy consultation process to develop the sub-national insolvency procedures, as interests of different parties – the national treasury, lenders, and municipal government – had to be synthesized.** Two constitutional amendments paved the way for a municipal insolvency mechanism.[21] The Municipal Finance Management Act of 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 other spheres of government and courts in the

[18] Examples are Butterworth, Noupoort, Ogies, Stilfontein, Tweeling, and Viljoenskronn (Glasser, 2005).
[19] The Development Bank of South Africa has provided lending at sub-market rates for many years and greatly distorted the municipal finance market.
[20] South Africa National Treasury (2001), at 192-193.
[21] South Africa Act No 34 of 2001 and Act No 3 2003. One amendment was needed for the financial emergencies provisions. The other was necessary to authorize a council to bind its successors, and thus the municipality as a corporate entity.

insolvency mechanism, and outlines the process of fiscal and debt adjustment. Only courts can stay debt payments and discharge debt obligations.

48. **Brazil has opted for an administrative approach to sub-national insolvency, in contrast to the United States and South Africa.** From the 1980s to 1997, Brazil experienced three state debt crises.[22] In the first two crises, the federal government bailed out insolvent sub-national entities by restructuring the sub-national debt. The third and largest debt crisis was resolved through the *conditional* bailout in 1997. The federal government restructured the states' debt, equivalent to 11.5 percent of GDP, but the restructuring was conditioned on their fiscal reforms. This adjustment program tackled the root causes of insolvency and undertook comprehensive fiscal reforms. In 2001, the debt of most major municipalities was restructured in an identical fashion to the 1997 state debt restructuring.

49. The debt restructurings of 1997 and 2001 in Brazil were successful in improving the fiscal balances of states and municipalities. However, the hierarchical controls embodied in the adjustment program and Fiscal Responsibility Law have their limitations. As states will return to the market to borrow starting in several years' time, there is ongoing discussion in Brazil on planning for an orderly and gradual return to the market within a legal framework that is more conducive to an efficient market for debt, rewarding states with good fiscal performance, while providing incentives for less well performing states and municipalities to continue to improve their fiscal performance.

Country context considerations

50. **The lack of a sub-national insolvency procedure is a smaller concern where higher levels of government exercise tight control over sub-national borrowing.** Also, if a country relies largely on relationship-based banking, the need for an insolvency framework is less pressing, although the hard budget constraint needs to be at the center of debt restructurings. However, as countries decentralize expenditure, taxation and borrowing, sub-national insolvency procedures become more relevant. It also becomes more important with the deepening of sub-national capital markets; a large number of bondholders exacerbate the collective action problem.

51. **In many developing countries, a few lenders, particularly the public lending institutions, dominate the domestic supply of sub-national credits.** This can imply that a lack of incentives for monopolistic creditors to price returns and risks undermines the effectiveness of insolvency mechanisms. In the case of Turkey, Iller Bank's role in passing-through fiscal transfers to its borrowers makes it unlike a commercial creditor, although this special arrangement will change if the reform law is passed. Sub-national 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.

[22] See Ter-Minassian (1997) and Dillinger (2002).

52. **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 sub-national 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. Formal procedural guidelines might be a stepping stone in the medium term.

IV. KEY ISSUES IN THE DESIGN OF INSOLVENCY MECHANISMS[23]

53. **There are several major considerations in designing insolvency procedures—namely, the fundamental differences between public and private insolvency, the choices between judicial or administrative approaches, and the operation of the insolvency procedure itself, which has three basic elements.** The central challenge is the resolution of the differing interests between creditors and the insolvent borrower, and among creditors.

Public versus private insolvency

54. **The public nature of the services provided by governments explains the fundamental difference between public insolvency and the bankruptcy of a private corporation.** This factor leads to the basic tension between protecting creditors' rights and maintaining essential public services. Creditors' remedies against defaulting sub-nationals, as opposed to corporations, are narrower, leading to greater moral hazard (strategic defaults). Whereas a private corporation is able to self-dissolve, this route is barred for sub-national governments. When a private corporation goes bankrupt, all assets of the corporation are potentially subject to attachment. By contrast, the ability of creditors to attach assets of sub-national governments is restrained in many countries because essential services must continue to be provided to the people. In the case of sub-national insolvency, the insolvency mechanism is generally a type of reorganization, not liquidation of all assets.

55. **This core difference 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.[24] In this sense, the satisfaction of creditor claims is subject to an absolute functional limit: the protection of the core functions of the sub-national entity.

56. **The public nature of sub-national insolvency results in a number of insolvency design features unique to sub-nationals.** Defining "insolvent" in terms of 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

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[23] This section draws from Liu and Waibel (2008a).

[24] 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.

independent of the sub-nationals' financial condition. The overarching aim of the procedure is thus financial rehabilitation of the debtor, and maximum recovery for creditors consistent with this objective.

Judicial or administrative approach

57. **There are two alternative approaches to sub-national insolvency: the judicial and the administrative.** Various hybrids also exist. Judicial procedures place courts in the driver's seat. Courts make key decisions to guide the restructuring process, including when and how a municipal insolvency is triggered, and a priority structure for settling competing claims. Because the debt discharge is highly complex, the judicial approach has the advantage of neutralizing political pressures during the restructuring. However, because mandates for budgetary matters lie with the executive and legislature in many countries, the courts' ability to influence fiscal adjustment of sub-national entities is extremely limited. 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.

58. **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 sub-national's sphere of responsibility can be problematic, because of the political nature of rights and obligations. 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.

59. **The choice of approach varies across countries, depending on the history, political and economic structure, and motivation for establishing an insolvency mechanism.** In Hungary, a desire to neutralize political pressure for bailing out insolvent sub-national governments favored the judicial approach. South Africa's legal framework for municipal bankruptcy is a hybrid, blending administrative intervention with the role of courts in deciding debt restructuring and discharge.[25] It uses sequential administrative interventions in the event of municipal financial distress: an early-warning system consisting of various indicators, intervention by provincial governments, and then intervention by the central government. Meanwhile, municipalities in South Africa can appeal to courts for staying, restructuring, or discharging debt.

60. **The United States uses both judicial and administrative approaches.** In response to widespread municipal defaults during the Great Depression, the U.S. Congress adopted a municipal insolvency law in 1937, known today as Chapter 9 of the U.S. Bankruptcy Code. The primary aim of this legislation was to deal with the holdout problem.

[25] South Africa has three spheres of government: federal, provincial, and municipal. Provinces generally do not borrow from the financial market.

The mandamus writ was recognized as useful for enforcing unpaid discrete obligations; it is ineffective if the sub-national is generally unable to pay.[26]

61. **Chapter 9 is a debt restructuring mechanism for political subdivisions and agencies of U.S. states.**[27] It provides the procedural machinery whereby a debt restructuring plan acceptable to a majority of creditors can become binding on a dissenting minority. Many states have adopted their own frameworks for dealing with municipal financial distress, for two reasons. First, municipalities are political subdivisions of the states. Second, state consent is a precondition for municipalities to file for Chapter 9 in federal court. That requirement 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. No uniform approach exists across states: 21 of the 50 states give blanket consent, 3 states attach important conditions, and 27 states grant permission on a case-by-case basis (see Laughlin 2005). New York City's bankruptcy in 1975 and Ohio's early-warning system for monitoring the financial health of municipalities are two examples of direct state involvement in resolving financial distress.

62. **As noted earlier, Brazil has opted for an administrative approach to sub-national insolvency.** In 1997 the conditional bailout of states, entailing a debt restructuring agreement between states and the federal government, enforced a whole range of sub-national fiscal reforms. 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 in 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. Discussions are ongoing in Brazil on the success and limitations of states and municipal fiscal and debt adjustment and how to move toward a more market-based incentive system.

Three Basic Elements of Insolvency Procedures

63. **Judicial or administrative, any insolvency mechanism contains three central elements.** These are: (i) definition of the trigger for the procedure, (ii) fiscal adjustment by the debtor to bring spending in line with revenues and borrowing in line with the capacity to service debt, and (iii) negotiations between debtor and creditors to restructure debt obligations and potential relief. Annex 1 summarizes insolvency procedures in U.S., Hungary and South Africa.

[26] The *mandamus* is a court order obliging public officials to take a certain course of action. For an excellent account on the mandamus and its motivation for Chapter 9, see McConnell and Picker (1993).

[27] The enactment of the statute was one more step in a series of regulatory reforms on sub-national borrowing since the first sub-national debt crisis in the early 1840s. After the 1840s crisis, 12 states adopted new constitutions, and 11 of the 12 required that the 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 (Wallis 2004).

Triggers

64. **Specific legal definitions serve as procedural triggers for initiating insolvency proceedings.** While the United States and Hungary define *insolvency* as inability to pay, South Africa chose one set of triggers for serious financial problems and another set of stronger triggers for persistent material breach of financial commitments.[28] In all three countries, the bankruptcy code empowers the court to dismiss petitions not filed in good faith. Because bankruptcy procedures have the power to discharge debt, a sub-national entity may file purely for the purpose of evading debt obligations. The U.S. Bankruptcy Code erects obstacles to municipal filing beyond those faced by private debtors, thereby discouraging strategic municipal bankruptcy filings.[29]

65. **Who can file for bankruptcy? The class of eligible filers differs across countries.** In the United States, under section 109(c)(2) of Chapter 9, only the municipality can file for bankruptcy, conditional on being insolvent, having worked out or attempted to work out a plan to deal with its debts, and having been authorized by the state to file for bankruptcy. The more stringent requirement for filing under Chapter 9, as compared with filing under Chapter 11, is due to the constraint set by the U.S. Constitution. A creditor cannot bring a municipality into a federal court against its will, based on the Constitution's 11th amendment. Like Chapter 9, Schwarcz's (2002) model law for sub-national insolvency allows only municipalities to file. In South Africa, under chapter 13, section 151(a), of the 2003 Municipal Financial Management Act, any creditor can trigger the financial emergency procedure. Similarly, in Hungary, a creditor can petition the court if a municipality is in arrears for more than 60 days.[30]

Fiscal Adjustment

66. **Fiscal adjustment is inherent to any insolvency procedures.** Often a sub-national government's own fiscal mismanagement is the root cause of insolvency. Macroeconomic shocks, such as a sharp rise in real interest rates through a currency crisis, can also trigger insolvency. Ianchovichina, Liu, and Nagarajan (2007) present a

[28] In Chapter 9 of the U.S. Bankruptcy Code, *sub-national insolvency* is defined as the debtor either (a) currently not paying its debts as they become due, unless such debts are the subject of a bona fide dispute, or (b) not being able to pay its debts as they become due. According to Hungary's 1996 Law on Municipal Debt Adjustment, the two central triggers occur if: (a) the debtor 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, or (b) the debtor has not paid a recognized debt within 60 days of date due.

[29] Only municipalities face a statutory requirement of insolvency. Section 109(c) imposes a procedural bar that is unique to Chapter 9 debtors: It requires prefiling efforts by the municipal debtor to work out its financial difficulties. The debtor must have reached agreement toward a plan or must have failed to do so despite good faith negotiations, or such negotiation must be "impracticable." Also, municipalities need state authorization to file for bankruptcy [section 109(c)(2)].

[30] See the Law on Municipal Debt Adjustment (Law XXV, 1996). Four years after the law was enacted, neither vendors nor banks petitioned for bankruptcy. According to Jókay, Szepesi, and Szmetana (2004), these creditors probably assumed that the local governments had few liquid assets and that operational cutbacks could not produce a cash flow sufficient for fully satisfying claims.

framework for analyzing sub-national fiscal adjustment. Although national and sub-national debt dynamics are alike, they are qualitatively different in several ways.

67. **Sub-national fiscal adjustment is complicated by the respective legislative mandates of central vis-à-vis sub-national governments and the intergovernmental fiscal system.** Unable to issue their own currency, sub-national governments cannot use seigniorage finance. They cannot freely adjust their primary balance because of a number of factors: legal constraints on raising their own revenue, varying dependence on central government transfers, and central government influences on key expenditure items such as wages and pensions. If public sector banks dominate lending, lending rates could be subsidized and credit risk concerns could be compromised.

68. **Fiscal adjustment often requires difficult political choices of cutting expenditure and raising revenues.** This is true even in a decentralized system such as that in the United States, where sub-national governments have broad freedom to control expenditures, raise revenues, influence their local economic growth, and affect the interest rate spread in a competitive capital market.

Debt Restructuring

69. **Debt restructuring lies at the heart of any insolvency framework.** In administrative interventions, the higher level of government often restructures sub-national debt obligations into longer-term debt instruments. The 1997 debt agreements between the Brazilian federal government and the 25 states might be viewed as an *ex post* debt restructuring. Another example is the debt restructuring of New York City by the state of New York in 1975.

70. **The debt discharge, however, is a major departure from the principle that contracts ought to be fulfilled.**[31] Insolvency law reconciles this clash of creditor rights and inability to pay. It formalizes the relationship between creditors and the debtor, and preserves the legal order by superseding contractual violations with a new legal act. Discharges are typically limited to judicial mechanisms to ensure the fairness of discharges. *Ex post* modification of contracts needs to be tightly circumscribed. If creditors feel that they are treated unfairly, there is a substantial risk that they will stop lending. Perceptions of what is equitable are likely to differ across countries because distributional judgments are involved.

71. **Debt restructuring and debt discharge are complex.** But one basic question is who holds the cram-down power when both sides fail to reach an agreement.[32] Under Chapter 9 of the U.S. Bankruptcy Code, municipal debtors propose the debt adjustment plan, which may modify the terms of existing debt instruments. Such adjustment plans may be adopted over the objection of holdout creditors. Chapter 9 incorporates basic Chapter 11

[31] In the United States, the Contracts Clause of the U.S. Constitution (article I. section 10, clause 1) puts the principle of good faith in contracts into constitutional form.

[32] Cram-down involves court confirmation of bankruptcy plans despite opposition of certain creditors. Under section 1129(b) of Chapter 11 of the U.S. Bankruptcy Code, courts may thus confirm a plan if it (a) was accepted by at least one impaired class, (b) does not discriminate unfairly, and (c) is fair and equitable.

requirements: at least one impaired class of claimants approves the plan, and secured creditors must receive at least the value of the secured property. Unsecured creditors thus often lose out.[33]

72. **In Hungary, the Debt Committee is chaired by a court-appointed independent financial trustee.** Under the Law on Municipal Debt Adjustment (Law XXV, 1996), the committee prepares a reorganization plan and debt settlement proposal.[34] The plan and proposal are adopted by majority vote of the committee and are 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. The law also stipulates the priority of asset distributions. If disagreements arise on distribution, the court makes the final decision, which cannot be appealed.[35]

73. **South Africa's legislation stipulates that debt discharge and settlement of claims must be approved by the court.** The settlement of claims takes the following order: (i) secured creditor, provided that the security was given in good faith and at least six months before the mandatory intervention; (ii) preferences provided by the 1936 Insolvency Act; and (iii) non-preferential claims.[36]

74. **The maturity of the legal system influences the choices of procedure.** Implementation of insolvency procedures rests on the shoulders of insolvency experts and depends 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 is usefully on developing institutional ingredients and on training bankruptcy professionals. In countries where the judicial system is undergoing transition, 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, buttressing concerns about a lack of substantive restructuring expertise (Gitlin and Watkins 1999).

V. QUESTIONS FOR THE FUTURE AND POSSIBLE REFORM OPTIONS FOR TURKEY

75. **Turkey has made significant progress toward establishing a regulatory framework for sub-national borrowing and debt management.** It has substantially strengthened *ex ante* fiscal rules for sub-national governments. Building on these, there are a number of areas where Turkey can benefit from international experience. Below proposes options for policymakers to consider in selected areas.

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

[34] Chapter II, section 9(3), of the Law on Municipal Debt Adjustment stipulates the financial trustee's independence.

[35] Assets are distributed to creditors in the following order: (a) regular personnel benefits including severance pay; (b) securitized debt; (c) dues to the central government; (d) social insurance debts, taxes, and public contributions; (e) other claims; and (f) interest and fees on debt obligations incurred during the bankruptcy proceeding. Chapter IV, section 31.

[36] Chapter 13, section 155(4), of the Municipal Finance and Management Act, 2003.

Further strengthening ex ante fiscal rules

76. **First, discretionary application of borrowing limits could be eliminated permanently**. Turkey may find Colombia experience useful. Law 358 "Traffic Light Law" (1997) and Law 819 (2003) sought to limit sub-national debt to payment capacity. The traffic light system classifies a sub-national government into either red or green light zone. To eliminate discretions, the original yellow light zone was eliminated. The red light zone is defined by interest over operational savings greater than 40 percent, and debt stock over current revenues greater than 80 percent. Sub-national governments in the red light zone are prohibited from borrowing.

77. **Second, Turkey could consider developing borrowing rules for municipal companies which are operated as private legal entities but whose liabilities may implicate public funds.** The legal arrangements for the public audit of these companies are not rigorous and do not take adequate account of the financial risks that these companies pose for the finances of the local administrations that own them.

78. **Turkey may find the experience of other middle income countries helpful in this regard.** In Brazil, although the most important state owned enterprises have been privatized, there are still state enterprises. The Fiscal Responsibility Law requires the disclosure of information concerning the consolidated public sector, including state owned enterprises. China is piloting Standard & Poor credit rating of municipal investment companies owned by Chongqing municipality (population 31 million), to establish a benchmark for market-based monitoring of municipal companies which have become the pillar of infrastructure-led growth in China.

79. **Third, more countries are moving toward the "golden rule" of public finance, i.e., borrowing is limited to financing investments, or equivalently, a balanced budget rule.** Some European countries, such as Germany and the United Kingdom, have enacted fiscal rules of a balanced budget net of public investment (the "golden rule").[37] Peru specifies that borrowing be solely to finance infrastructure projects. Russian requires that, in provisions relating to regional governments, current expenditure may not exceed total revenues and borrowing may be used only to finance investment expenditures. South Africa's constitution prohibits long-term borrowing for consumption expenditure.[38] The fiscal responsibility legislation for India's states requires current expenditure not exceeding total revenue, so that borrowing is only for investment. Balanced budget rules are common

[37] Short-term borrowing for working capital is still allowed, but provisions should be built in to prevent governments from rollover borrowing as a way of long-term borrowing for operating deficits.

[38] Section 230A distinguishes between short-term and long-term borrowing – specifying that borrowing for current expenditure is allowed but must be repaid within the year, while borrowing for capital expenditure must be longer-term.

in the U.S. states.[39] There are analytical and implementation challenges associated with the golden rule and there have been considerable discussions in Turkey on this topic.[40]

Developing an effective insolvency system

80. **Turkey could also look to the experience of other countries for practical lessons in the design of an insolvency system.** As mentioned in Section II, the legal framework in Turkey does not currently provide a clear mechanism for resolution of municipal insolvencies, and there are no precedents that provide guidance. Given the respective role of different parts of the government – executive, legislative, and judicial – a country will need to find its own insolvency design that fits the country's political reality and the evolving intergovernmental fiscal system.

81. **Developing an insolvency system is a long-term effort in any country, and involves many decision points.** Here we point out some key issues. Defining triggers is a starting point involving indicators of financial and service delivery problems. Respective roles of different branches of the government would also need to be defined including the potential for an independent financial recovery agency, a trustee, curator, or executor. Another issue relates to the effect of restructuring on the existing council and management and if either or both can be dissolved, and if so under what circumstances. As an insolvency system addresses fiscal adjustment and debt restructuring, an insolvency framework would need to delineate who decides which aspects of fiscal and debt restructurings, such as expenditure controls, revenue measures, legal proceedings, or stays of legal process, debt discharges, imposition of a recovery plan, and a priority structure for settling competing claims. The insolvency system would also need to define the process of notices, consultation with government and creditors, and other stakeholders with respect to key steps such as intervention, recovery plan, and debt discharge.

82. **Insolvency mechanisms are not sufficient for enforcing hard budget constraints.** While this paper has focused on the role of an insolvency mechanism, there is a broader content, beyond the scope of this paper, of a multifaceted, medium-term process of developing a sustainable sub-national finance system. Specifically, for example, it is helpful to sequence the reform of *ex post* debt restructuring with other reforms, including

[39] For Peru, see Fiscal Decentralization Law (2004), article 24, and General Debt Law (2005), article 51). For Russia, see Budget Law (1998). For South Africa, see South Africa National Treasury 2001: 192). For India, see various state Fiscal Responsibility Legislation.

[40] A balanced budget rule necessarily implies that investment is financed by debt instruments, although there are challenges of classifying what counts as investment expenditure. Because of fungibility, without a balanced budget rule, one can easily borrow to finance debt service, for example. When borrowing it is critical to link the beneficiaries of the expenditure so financed, to the debt service. Borrowing has cost, so creditors worry about securitization of debt, that is, about an identifiable stream of revenues to service the debt. If such revenue streams are not easily identifiable, then the credit worthiness of the borrower (in this case a municipality) becomes important. If a local government can manage its deficit to a manageable level, then it can afford to borrow because it can afford to service the debt. In general, capital markets have an aversion to persistent operating deficits (a non-balanced budget). Of course, the golden rule is not a sufficient condition for making sure that capital investment leads to growth which would pay debt service. Capital budgeting, financial management, cost benefit analysis, and a system of accountability are among key factors for efficient public investments.

an intergovernmental fiscal system that can provide incentives for sub-national governments to sustain a high revenue effort and exercise self discipline in fiscal affairs

Developing a diversified competitive sub-national credit market

83. **Diversified and competitive sub-national credit markets, a long-term reform objective, help lower borrowing cost and extend maturity for sub-national borrowers.** In South Africa, a primary objective of developing sub-national insolvency procedures after the fall of apartheid was to develop a competitive and diversified credit market for sub-national borrowers (South Africa National Treasury 2001: 192–93). The government's White Paper on Local Government (1998) stressed the importance of private investments in the municipal bond market. Sub-national bonds increasingly compete with traditional bank financing in countries such as Mexico, Romania, Russia, and South Africa, and private financing of municipal infrastructure is emerging in China. The ongoing global financial crisis has strained the sub-national credit markets. Over the medium and longer terms, however, the importance of developing diversified sub-national credit markets in developing countries remains. Progress in the government's planned reform of Iller Bank would be an important step in this direction.

84. **A more competitive, diversified sub-national credit market can provide access to credit based on assessed creditworthiness.** Information resources in the form of rating agencies and new accounting standards are developing in Turkey, and some commercial capital is being provided to the most creditworthy municipalities. Complete reliance on the market would be premature and unwise, but gradual reforms can be undertaken to encourage market initiatives. Legal requirements that market participants disclose information can help the markets work more transparently. National consistency in the exercise of intervention powers for insolvency is important for stabilizing the relationship between local administrations and financial markets. Steps contemplated by the Treasury, such as allowing local administrations to hold deposits in private banks, can encourage such private credit access. However, tapping such sources of private finance unburdens the central government of potential fiscal demands only insofar as the Government establishes clearly that it will not guarantee local administration debts. The continuation of the other reforms discussed in this note would help ensure this desirable outcome of greater recourse to sustainable private financing for local administrations.

Improving sub-national fiscal accounts

85. Strong budget transparency and accountability are further essential ingredients. This has been improving in Turkey with the introduction of modified accrual accounting, but providing budget information and financial statements for the ancillary entities (municipal companies) would provide greater clarity and assurance to potential financiers.

86. **The heterogeneity of municipalities will also imply that the quality of sub-national fiscal accounts is likely to vary for quite some time.** It will be challenging to have over 2,000 municipalities submit quality data on a regular basis. The government can explore means of sharing financial data across agencies rapidly, including alternative

estimates of key variables that would later be reconciled for consolidated public finance accounts. This will include the design of common and simplified reporting formats for income statement and balance sheet, with features that permit automated consistency checking. Such automatic testing of the data could also assist in speeding the reconciliation process. There is now a wealth of experience in designing and implementing Integrated Financial Management Information System in a number of countries.[41] Administrators of municipalities and municipal companies may need to be trained to prepare and execute the budget.

87. **Although legislation to allow sub-national borrowing cannot favor selected sub-national governments, differentiation could be designed as self-selective**. That is, only those sub-national governments that have adopted fiscal transparency and budgetary reforms could be allowed to access the markets. Such differentiation is somewhat implicit in the Treasury's own system of rating local administrations for guarantees.

Sub-national credit ratings

88. **Sub-national credit ratings by independent rating agencies are a pre-condition for a municipality to access the capital market in a number of countries**. They also help strengthen fiscal transparency. Several middle income countries such as China, India, Mexico, Poland, Russia, and South Africa have introduced rating of sub-national governments by international rating agencies. Mexico's reform experience in linking credit rating with sub-national credit supply is useful to other developing countries. Mexico introduced a credit rating system for sub-national governments as part of its new sub-national borrowing framework. Although sub-national participation in the credit rating is voluntary, the requirements of the capital-risk weighting of bank loans introduced in 2000 and of loss provisions introduced in 2004, aim at imposing sub-national fiscal discipline through the market pricing of sub-national credit.

89. **Some metropolitan municipalities in Turkey have already obtained independent credit ratings, and several more are planning to do so.** When sub-national governments seek to borrow from private capital markets, it can be useful to encourage the practice of commercial ratings.[42] These ratings can offer a reward to local administrations that perform well, and start to build the information base necessary to foster private interest in lending to municipalities. Such ratings will nonetheless have important limitations in the short term. Since local administrations do not have a clearly articulated arm's length relationship with the central government, any rating is bound to

[41] See for example USAID (2008) http://pdf.usaid.gov/pdf_docs/PNADK595.pdf for a useful overview.

[42] Although sovereign ratings are usually reliable predictors of sovereign default risk, various authors observe that the credit rating agencies were not able to predict and to warn the market participants of the imminent default risks with the onset of financial turbulences and crisis. See for example, Reisen and Maltzan (1999) and Reihard (2002). Criticism of the rating agency role in the current financial crisis relates mainly to structured finance ratings and banks, and not to subnational government ratings. The ongoing financial crisis is also expected to lead to changes in the rating system for financial institutions and financial instruments such as mortgage-backed securities.

blend an assessment of the likelihood of central government support with the assessment of a local administration's creditworthiness.

90. **Independent ratings in the context of bond issuance, particularly for the larger municipalities, can be a useful tool for helping move towards a more market-based sub-national credit supply system.** However, until a critical mass of rated market transactions take place, ratings typically do an inadequate job of predicting risk and pricing. Rating agencies will almost certainly face the same limitations of unreliable and incomplete data on local administration finances as central government does now. Steps that have been undertaken by the Government to improve quality of sub-national fiscal accounts will help fiscal transparency and credit ratings.

Concluding remarks

91. **Developing a robust system of sub-national borrowing is a long-term effort in any country, and involves many decision points.** In South Africa, for example, the broad principles were laid out in a government White Paper on Local Government 1996, which was then developed into a detailed policy paper on Municipal Borrowing in 1999 and adopted by Cabinet as official policy in 2000. The legislation and constitutional amendments were enacted by Parliament over the ensuing three years, and implementation is still underway.

92. **The process of building the institutional framework for sub-national borrowing in Turkey has been evolving rapidly but is recognized as a continuing work in progress.** This policy note may serve as only one input to the Government's ongoing evaluation of the experience.

Annex 1: Main Elements of Sub-national Insolvency Procedures: A Country Comparison[43]

	Hungary	South Africa	United States
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[44]	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.
Sub-national 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 since1945, substantial number of settlements and state procedures.

[43] Table source: Liu and Waibel (2008a). The legislation for the three countries is as follows. Hungary: *Law on Municipal Debt Adjustment, Law XXV*, 1996; South Africa *Municipal Financial Management Act, 2003.* United States, *Chapter 9 of the US Bankruptcy Code*, 1938. For the United States, this table covers only Chapter 9, not fiscal and debt adjustments for local governments by states outside Chapter 9.

[44] Adjustment measures which may be prescribed in exchange for a restructuring/debt relief.

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